

CRYPTO FUNDAMENTALS

Custody and why the legal issues surrounding it matter

BY JESSE KANACH, DANA SYRACUSE, JOSHUA BOEHM AND THOMAS AHMADIFAR

ABSTRACT

- *Fiduciaries are the bedrock of US financial laws, policies and capital providers. By acting in the best interest of their clients, fiduciaries allow a system of transactions and savings to operate through trusted representatives.¹*
- *US federal and state securities, trust, retirement and banking laws embed both technical standards and common-law fiduciary principles throughout the financial infrastructure in a way that is now so well established that consumers feel secure in trusting their assets to representatives. Many can take for granted that their traditional assets are held by a trusted party: the custodian. While this assumption holds true for traditional assets, the custody of new generations of ‘crypto-assets’ poses challenges, given the existing commercial and regulatory realities.*
- *Crypto-assets² have, among other disruptive effects,³ forced an industry to step back and consider how established rules and principles should apply to something fundamentally new. Despite the technical challenges that blockchain poses for traditional models of custody, custodians remain crucial for commercial and regulatory reasons.*
- *This article discusses some of the business and legal needs for custodians in the US financial system, and why crypto-assets will require new developments in custodial offerings as blockchain establishes a greater footprint in the institutional financial world.*

¹ Tamar Frankel, *Fiduciary Law*, 71 Calif L Rev 795, 823 (1983) (explaining that a fiduciary must act with loyalty and skill in the client’s best interests)

² Referred to as such throughout this article to intentionally use a term broad enough to encompass virtual currencies, utility tokens, tokenised securities, and other digital assets represented on the blockchain

³ E.g. Joichi Ito, Neha Narula and Robleh Ali, *The Blockchain Will Do to the Financial System What the Internet Did to Media*, Harv Bus Rev, hbr.org/2017/03/the-blockchain-will-do-to-banks-and-law-firms-what-the-internet-did-to-media

What is ‘custody’ and how does it relate to fiduciaries? ‘Custody’ is defined in different ways, depending on its purpose. At its core, custody relates to an arrangement under which an asset is recognised as being owned, or otherwise possessed by a person, on the person’s own behalf or on behalf of another. A key priority of a custodian is to safeguard an asset from being stolen and to provide a mechanism for transferring the asset. Before allowing a financial asset to be transferred from a custodial account, a custodian ordinarily requires evidence that the person directing the transfer has authority to do so.⁴ A custodian will need procedures for extraordinary events, such as how to comply with a court order to stop an asset from being transferred.

A custodian tends to provide other services that relate to its core mission, and may be subject to varying duties depending on the nature of the service and how it is regulated. Fiduciaries exist throughout the US financial regulatory ecosystem and are defined, and made subject to fiduciary duties, in different ways for different purposes. The *Investment Advisers Act of 1940* (the Advisers Act) imposes a fiduciary duty on investment advisers.⁵ Investment company directors and fund management companies owe fiduciary duties to registered investment funds under the *Investment Company Act of 1940* (the 1940 Act), as well as under state law and common law.⁶ Banks in the US undertake a number of fiduciary obligations under a series of Acts,

including the *Banking Act of 1933* and the *Financial Institutions Supervisory Act of 1966* (FISA).⁷ Regardless of express technical requirements, a common obligation of fiduciaries is to ensure the safekeeping of client assets by either using or acting as a custodian.⁸

CUSTODIANS AND CUSTODY: THE LEGAL ISSUES

Custodians provide different custodial services depending on the roles they play as fiduciaries, the relevant regulatory requirements applicable to them, or the financial institutions (FIs) that use them.⁹ Depending on the context, custodians can be banks, broker-dealers, futures commission merchants (FCMs)¹⁰ or certain types of foreign entities. Banks, in particular, are a critical type of custodian, due to the combination of the prudential regulations that emphasise safety and soundness, and the security and accounting services they customarily provide to their institutional and retail clients.¹¹ Banks and some broker-dealers have the physical and electronic systems to secure and hold assets.¹² They also provide clearing services, as well as notices to customers detailing how their assets are being held and account statements detailing holdings.¹³

Generally, under the US federal securities laws, regulated FIs have a fiduciary obligation to their clients to hold their assets with a particular type of custodian. For instance, investment advisers that are registered with the US Securities and Exchange Commission (SEC) are required to hold most kinds of funds and securities with ‘qualified

4 E.g. Office of the Comptroller of the Currency, *Comptroller’s Handbook: Asset Management Operations and Controls* 27 (2011), available at www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/asset-mgmt-ops-controls/pub-ch-asset-mgmt-ops-controls.pdf (requiring that a broker-dealer serving as a sub-custodian only accept or release funds or securities ‘upon receipt of instructions from authorised bank officers or employees provided in accordance with agreed-upon procedures’)

5 This article intentionally uses the spelling ‘adviser’ when discussing investment advisers. ‘Investment adviser’ with this particular spelling is a defined term under the Advisers Act. 15 USC § 80b-2(a)(11). The appropriate spelling of financial professionals’ names is a fresh topic for the US Securities and Exchange Commission, which included it as a key element of a recent rule proposal. *Form CRS Relationship Summary*, 83 Fed Reg 21,416, 21,459-69 (9 May 2018) (proposed rule). 15 USC Code (USC) § 80b-6 (2016) (s.206 of the Advisers Act); *Transamerica Mortgage Advisors v Lewis*, 444 US 11, 17 (1979) (‘[Section] 206 establishes “federal fiduciary standards” to govern the conduct of investment advisers ...’); *SEC v Capital Gains Research Bureau, Inc.*, 375 US 180, 191-92 (1963); SEC, *Information for Newly-Registered Investment Advisers* (23 November 2010), www.sec.gov/divisions/investment/advoverview.htm; see also J Tyler Kirk, *A Federal Fiduciary Standard Under the Investment Advisers Act of 1940: A Refinement for the Protection of Private Funds*, 7 Harv Bus L Rev Online 19, 25 (2016), www.hblr.org/wp-content/uploads/2016/12/T-Kirk_Private-Funds-FD-Published-2.pdf

6 15 USC § 80a-35(b) (s.36(b) of the 1940 Act); Investment Company Institute, *Understanding the Role of Mutual Fund Directors* (1999), www.ici.org/pdf/bro_mf_directors.pdf

7 FISA, Pub L No 89-695, § 101(a), 80 Stat 1028, 1030 (1966); *Banking Act of 1933*, Pub L 73-66, § 24(b), 48 Stat 162, 190 (1933)

8 E.g. SEC at note 5

9 Office of the Comptroller of the Currency, *Comptroller’s Handbook: Custody Services* 2 (updated 17 May 2012) (explaining that ‘a custodian providing core domestic custody services typically settles trades, invests cash balances as directed, collects income, processes corporate actions, prices securities positions, and provides recordkeeping and reporting services’), available at www.occ.gov/publications/publications-by-type/comptrollers-handbook/custody-services/pub-ch-custody-services.pdf; see also 17 Code of Federal Regulations (CFR) § 275.206(4)-2(d)(2) (2018) (defining ‘custody’ under the Advisers Act to mean, in part, ‘holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them’).

10 See glossary at end of article

11 The Clearing House, *The Custody Services of Banks* 3-7 (2016), www.theclearinghouse.org/research/articles/2016/07/-/media/8731fd83fbd34c38ac0aa9d02a9f682d.ashx

12 *Id.* at 4-5

13 17 CFR § 275.206(4)-2(a)(2)-(3); see also The Clearing House, note 11, at 3-7

custodians'.¹⁴ Although relatively straightforward for traditional types of assets, the analysis of whether that requirement applies to crypto-assets can be complicated and may depend on the specific form of crypto-asset and whether or not the crypto-asset is a 'security' under the US federal securities laws.¹⁵ For instance, one test the SEC has applied to crypto-assets to determine whether the asset is a 'security' under the *Securities Act of 1933* (the Securities Act) requires examining four prongs to determine whether the asset is a security: whether there was an investment of money (1); in a common enterprise (2); with an expectation of profit (3); and derived from the efforts of others (4) (the *Howey Test*).¹⁶ However, because of the transformative nature of some tokens, the *Howey Test* may not be the final analysis.¹⁷ Because the *Howey Test* is a 'facts and circumstances' analysis, it may be possible that the classification for some tokens under the US federal securities laws could change as their facts and circumstances shift, and therefore the custody obligations for such crypto-assets could change as well.¹⁸

'As more mainstream commercial enterprises begin transacting in crypto-assets, there will likely be increasing commercial demand for a third-party fiduciary to hold those assets'

A custodian that is subject to prudential regulation and that undertakes fiduciary duties to its customers would be an attractive option for safekeeping of crypto-assets, regardless of the type of FI or commercial enterprise. For instance, the Advisers Act requires a qualified custodian to be used, because an investment adviser (registered or not) is subject to a fiduciary duty with respect to the safekeeping of client assets and must act in the best interest of its clients.¹⁹ Likewise, under the 1940 Act, investment companies must also use custodians, such as banks, to hold funds' securities and other property.²⁰ Even beyond FIs and their regulatory obligations, some commercial enterprises currently holding crypto-assets may have technical familiarity with blockchain technology and are comfortable maintaining private keys themselves or through a hosted wallet provider.²¹ However, as more mainstream commercial enterprises begin transacting in crypto-assets, there will likely be increasing commercial demand for a third-party fiduciary to hold those assets. Because of their role as 'qualified custodians' under the US federal securities laws, banks, broker-dealers,

14 17 CFR § 275.206(4)-2(a) (the Custody Rule) and § 275.206(4)-2(d)(6) (defining 'qualified custodian'). Also 15 USC § 80b-2(a)(2) (defining 'bank' under the Advisers Act to mean a banking institution organised under the laws of the United States or a federal savings association; a member bank of the Federal Reserve System; any trust company doing business under the laws of any state or 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 authorities having supervision over banks or savings associations and which is not operated for the purpose of evading the provisions of the Advisers Act; and certain other defined types of banking institutions); and § 78o(b)(1) (defining 'broker-dealer' under the *Securities Exchange Act of 1934* (the Exchange Act) to mean someone who effects transactions in or induces the purchase or sale of any security); 7 USC § 1a(28)(B) (defining an FCM under the *Commodity Exchange Act* to mean 'any person who engages in soliciting or accepting orders for, or acting as a counterparty in, any agreement, contract, or transaction subject to this chapter, and who accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom'); 17 CFR § 275.206(4)-2(d)(6)(iv) (defining an eligible foreign financial institution to be one that 'customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets'). Certain New York or other state-chartered trust companies may meet the definition of 'qualified custodian' depending on their structure, supervision, and the nature of their authority.

15 Molly Moynihan and Dana Syracuse, 'Blockchain, Tokens, and Mutual Funds - We're Not There Yet', *The Investment Lawyer*, July 2018, at 5; see also William Hinman, Director, Division of Corporate Finance, SEC, Remarks at the Yahoo Finance All Markets Summit: Crypto (14 June 2018), available at www.sec.gov/news/speech/speech-hinman-061418#_ftn1 (discussing when a crypto-asset can be a security, and 'whether a digital asset offered as a security can, over time, become something other than a security').

16 SEC v *WJ Howey Co.*, 328 US 293, 298 (1946); see also *Report of Investigation Pursuant to s.21(a) of the Securities Exchange Act of 1934: The DAO*, Exchange Act Release No 81207 (25 July 2017) (applying the *Howey Test* to a token offering), available at www.sec.gov/litigation/investreport/34-81207.pdf (the DAO Report)

17 Hinman, note 15

18 Cryptocurrencies: *Oversight of New Assets in the Digital Age: Hearing Before the H Comm On Agric.*, 115th Cong 3-6 (2018) (statement of Lowell Ness, Partner, Perkins Coie LLP), available at agriculture.house.gov/uploadedfiles/071818_ness_testimony.pdf (explaining the lifecycle of a token from pre-functionality through post-functionality and decentralisation)

19 17 CFR § 275.206(4)-2(a); *Capital Gains Research Bureau*, 375 US at 194; see also *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, 83 Fed Reg 21,203, 21,204 (9 May 2018) (proposed interpretation) ('An investment adviser is a fiduciary, and as such is held to the highest standard of conduct and must act in the best interest of its client.')

20 15 USC § 80a-17(f); 17 CFR § 270.17f-4(a), (c)(6)

21 A description of private keys, wallets and other elements relevant to generating, acquiring, holding and transferring crypto-assets is outside the scope of this article. For a general introduction to blockchain in the context of investment management, see Jesse P Kanach, Andrew P Cross and Mary C Moynihan, 'As Fintech Platforms Grow Up, Investment Management Firms Face the "Problems of Tomorrow"', *The Investment Lawyer*, March 2017, at 4-6, available at <https://dpxtax5jbd3l.cloudfront.net/images/content/1/6/v2/168892/IL-0317-Kanach.pdf>

‘Custodians are necessary as the next step towards crypto-assets being seen as a safe and attractive financial asset option for large FIs and perhaps for market confidence in general’

FCMs and foreign institutions that offer custody of crypto-assets, particularly on a large scale, could give crypto customers confidence in terms of custody, given how new most institutions are to the crypto space.

CRYPTO-ASSET CUSTODY: THE NEXT FRONTIER

Custodians are necessary as the next step towards crypto-assets being seen as a safe and attractive financial asset option for large FIs and perhaps for market confidence in general. Although Bitcoin proponents claim that the Bitcoin blockchain has never been hacked,²² hacks of major crypto-asset exchanges around the world are common headlines.²³ Major institutional custodians providing a secure place to store large amounts of crypto-assets could provide the protection necessary to reduce the risk of hacks and increase the trust of the investing public in crypto-assets. In addition, with regulated custodians, such as banks (and similar institutions meeting the relevant regulatory definitions of ‘banks’), willing to take custody of crypto-assets, the market can open to a wide variety of FIs who may already be interested in crypto-assets, but who may have had to sit on the sidelines in order to ensure that they can meet their own fiduciary obligations.

However, part of the delay in the supply of available crypto-asset custodians is that there are inherent difficulties for those custodians seeking to provide crypto-asset services. For instance, custodial banks are part of an industry that started with vaults and safes, moved to electronic banking

and SWIFT payments in the not-so-distant past, and is now confronted with evaluating the best means of crypto-asset storage, private keys and blockchains. Some crypto-assets are maintained in hot storage mechanisms such as digital wallets, which are software programs that are connected to the internet and able to hold crypto-assets and allow for the processing of transactions. In maintaining hot storage mechanisms for customers, a bank custodian would be departing from centuries, or at least decades, of established custodial practices, given their networked nature, and may need to rely partly or even exclusively on third-party technologies. Such technologies might include those developed by digital wallet providers, which are companies or services that offer digital wallets to retail and/or institutional customers. Given the recent invention of crypto-assets, such technologies do not yet benefit from decades of testing or lessons learned. Cold storage, which involves the storing of crypto-assets entirely offline, operates like a physical vault, by requiring more interaction than is possible through online means.²⁴ Although hot storage mechanisms facilitate faster transactions due to their connectivity, they are far more susceptible to hacking and loss than cold storage mechanisms. As a practical and prudential matter, crypto-asset custodians would generally want to store the greatest possible amount of customer assets in cold storage, while keeping the minimum needed amount of such assets in hot storage to facilitate timely withdrawals (based on typical withdrawal volume and frequency).

22 Arvinda R, *Bitcoin Has Never Been Hacked... Oh Really?*, Medium (29 September 2017), medium.com/@vindard/bitcoin-has-never-been-hacked-oh-really-209123ab3dd7

23 E.g. Saheli Roy Choudhury, *South Korean Cryptocurrency Exchange Bithumb Says it was Hacked and \$30 Million in Coins Was Stolen*, CNBC (reporting on a drop in the price of cryptocurrencies following the hack of Bithumb exchange in South Korea), www.cnbc.com/2018/06/19/south-korea-crypto-exchange-bithumb-says-it-was-hacked-coins-stolen.html

24 Daniel Roberts, *Bitcoin Buyers Must Practice ‘Cold Storage’ for Security*, Yahoo Finance (13 December 2017), finance.yahoo.com/news/bitcoin-buyers-must-practice-cold-storage-security-192843363.html (explaining ‘cold storage’ as ‘keeping the access keys somewhere offline, not accessible to the Internet in any way’)

Moreover, legal and commercial issues relevant to traditional custodial vaults, such as physically safeguarding the asset, having a party accept liability for such safeguarding where required by law, and testing and insuring the vault's operations in order to reduce the potential for legal liability, can also pertain to crypto-asset storage. To be able to adequately take custody of crypto-assets, there are a number of educational, practical and regulatory steps banks and other custodians must successfully complete:

- Custodians must educate themselves on how blockchains work.²⁵
- Custodians must evaluate the number of existing means for secure crypto-asset storage, such as current digital wallet providers, the use of cold storage, the use of 'multi-signature' functionality and multi-signature wallets,²⁶ as well as monitor for new developments in the storage of private and public keys. ('Multi-signature' is sometimes abbreviated to 'multi-sig')
- Custodians must develop adequate technological capabilities to securely transfer, exchange and settle transactions in fiat currency and crypto-assets on exchanges, the SWIFT network, alternative trading systems (ATS), or regulated exchanges.²⁷
- Custodians may also have to apply for any applicable crypto-oriented licences, and potentially subject themselves to new regulatory regimes in the US and abroad.²⁸
- Custodians must implement policies and procedures to adequately conduct anti-money laundering and know-your-customer compliance on crypto-assets and crypto-asset customers in order to satisfy their obligations under the *USA PATRIOT Act* of 2001 and other federal banking laws.²⁹ This could be difficult for FIs with crypto-assets due

to the anonymous or partially anonymous nature of certain transactions. For instance, it may be difficult to identify the origins and destinations of transactions.³⁰

- Custodians should implement a set of protective measures that include network security, credential protection, disaster recovery, insurance and a means of backing up stored crypto-assets.³¹
- Any significant outstanding issues under the *Uniform Commercial Code*, transfer agency, tax and other critical parts of the existing holding-and-transfer protocols may need to be studied.
- Any digital-asset lending (akin to securities lending) practices would require custodians to evaluate their own internal policies and procedures to ensure compliance with any applicable regulatory regime relating to securities lending.^{32,33}

WHY DO THE LEGAL ISSUES SURROUNDING CUSTODY MATTER FOR CRYPTO-ASSETS THAT ARE SECURITIES?

In addition to being a means for a variety of fiduciaries to satisfy their legal obligations, having adequate custodial services for crypto-assets is also important to be able to maximise the financial markets' interactions with crypto-assets, regardless of the regulatory categorisation of each crypto-asset.³⁴ In the wake of the SEC's *DAO Report*,³⁵ which concluded that a crypto-asset could be a 'security' under the Securities Act, the crypto-asset industry is very focused on whether any given crypto-asset is a security under the federal securities laws.³⁶ The SEC and state regulators are constantly evaluating whether any given

25 E.g. note 21 (explaining the blockchain and how it works)

26 Ben Davenport, *What is Multi-Sig, and What Can it Do?*, Coincenter.org (1 January 2015), coincenter.org/entry/what-is-multi-sig-and-what-can-it-do (explaining 'multi-sig' as requiring multiple private keys in order to transact)

27 Office of the Comptroller of the Currency, note 9, at 2 (explaining that 'a custodian providing core domestic custody services typically settles trades, invests cash balances as directed, collects income, processes corporate actions, prices securities positions, and provides recordkeeping and reporting services'); 2017 Public-Private Analytic Exchange Program, *Risks and Vulnerabilities of Virtual Currency* 23 (2017), www.dni.gov/files/PE/Documents/9-2017-AEP-Risks-and-Vulnerabilities-of-Virtual-Currency.pdf ('Currently, financial institutions employ mature systems to store and transact on their networks. These systems include industry standards such as PCI and SWIFT, which deploy controls to protect consumer funds from theft and fraudulent transactions.')

28 E.g. Gibraltar Financial Services Commission, *Distributed Ledger Technology Regulatory Framework (DLT Framework)*, www.fsc.gi/dlt

29 *USA PATRIOT Act* of 2001, Pub L 107-56, § 326, 115 Stat 272, 317-318 (2001) (codified at 31 USC § 5318(l)); 31 CFR § 103.121

30 2017 Public-Private Analytic Exchange Program, note 27, at 22

31 *Id* at 23

32 Such as ss.17(f) and 18 of the 1940 Act

33 15 USC § 80a-17 (requiring generally that a fund's portfolio securities be held by an eligible custodian); and § 80a-18 (governing the extent to which a fund may incur indebtedness); SEC, *Securities Lending by US Open-End and Closed-End Investment Companies*, www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm

34 This section will highlight the need for custodians in the event that any given crypto-asset is deemed to be a security by the SEC or a court of law; however, similar considerations may also be necessary if a crypto-asset is deemed to be a US Commodity Futures Trading Commission (CFTC) regulated instrument

35 *DAO Report*, note 16

36 E.g. Bob Pisani, *Bitcoin and Ether Are Not Securities, but Some Initial Coin Offerings May Be*, *SEC Official Says*, CNBC, www.cnbc.com/2018/06/14/bitcoin-and-ethereum-are-not-securities-but-some-cryptocurrencies-may-be-sec-official-says.html; Michael S Didiuk et al, *Ether is not a Security: Summary of SEC Division of Corporation Finance Director Hinman's Remarks*, ABA Bus L Today (June 2018), businesslawtoday.org/month-in-brief/june-brief-securities-law-2018. For the purposes of this article, the term 'federal securities laws' refers to the Securities Act, the Exchange Act, the 1940 Act and the Advisers Act

‘Having appropriately qualified custodians that take custody of crypto-assets would allow interested parties to structure business models around becoming regulated actors, such as investment advisers or investment funds, in the crypto-asset space’

crypto-asset is a security in order to determine the nature of regulation that may apply.³⁷ However, if one were to move past the threshold question of whether any given crypto-asset is a security, it is important to also ask: what happens next? Why is this important? The answer relates back to a need for custody.

If a crypto-asset is deemed to be a security, a number of statutory and regulatory obligations are triggered.³⁸ For instance, under the Advisers Act, if an adviser advises on assets that are ‘securities’,³⁹ crypto or otherwise, then it must register with its appropriate regulator or qualify for an exemption from registration and, if it holds assets for clients, it may be required to use a qualified custodian. Similarly, under the 1940 Act, an issuer can inadvertently become an ‘investment company’ if it holds out that it invests in securities, or invests a certain percentage of its total assets in securities.⁴⁰ If an entity is an investment

company, then a number of regulatory obligations apply, among which is the requirement, under certain circumstances, to hold company assets with a custodian.⁴¹

If any given crypto-asset is deemed to be a ‘security’ under the US federal securities laws, having adequate custodial services in place would provide two major benefits for the industry. First, it would allow for more investment from established and responsible regulated entities. Regulated entities such as investment advisers and investment companies could safely and securely incorporate crypto-assets into their portfolios, regardless of the regulatory status of the assets themselves, if they, in turn, had a regulated institution in which to store such crypto-assets. Second, having appropriately qualified custodians that take custody of crypto-assets would allow interested parties to structure business models around becoming regulated actors, such as investment advisers or investment funds, in the crypto-asset space.

In the context of registered investment companies, such as mutual funds or exchange-traded funds (ETFs) that invest in securities, the SEC staff has specifically raised the issue of custody as a necessary hurdle to clear if investment companies want to directly hold crypto-assets. Dalia Blass, Director of the SEC’s Division of Investment Management, issued a letter to two industry groups in January 2018 that raised a number of open questions on which the SEC staff would like to gain clarity before it grants effectiveness to regulated funds that invest in crypto-assets.⁴² The letter specifically addressed custody and asked: ‘How would [a fund] satisfy the custody requirements of the 1940 Act and relevant rules?’ The letter also dug deeper and asked how a fund would ‘validate existence, exclusive ownership and software functionality of private cryptocurrency keys and other ownership records’. If such custody-related questions can be addressed to the satisfaction of the SEC staff, it could remove one of the barriers to the launch of registered mutual funds or ETFs that focus on crypto-assets

37 *Munchee, Inc.*, Securities Act Release No. 10445 (11 December 2017), available at www.sec.gov/litigation/admin/2017/33-10445.pdf; Hinman, note 15; *In re 18Moons, Inc.*, No. E-2018-0010, Mass Office of the Sec of the Commonwealth, Sec Div (27 March 2018), available at www.sec.state.ma.us/sct/current/sctcryptocurrency/MSD-18moons-Consent-Order-E-2018-0010.pdf

38 For the purposes of this discussion, we assume that any crypto-asset deemed a security was issued in compliance with the Securities Act and its implementing regulations, including any applicable exemptions from registration requirements

39 See 17 CFR § 275.206(4)-2(a)(1); see also 15 USC § 80b-2(a)(11) (defining ‘investment adviser’ as ‘any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities’)

40 15 USC § 80a-3(a)(1)(C); see also Joel S Telpner and Thomas M Ahmadifar, ‘ICOs, The DAO, and the Investment Company Act of 1940’, *The Investment Lawyer*, November 2017, at 6, available at www.sandw.com/assets/htmldocuments/ICOs%20The%20DAO%20and%20the%20Investment%20Company%20Act.pdf. See generally Brian Vito, *Revisiting the Inadvertent Investment Company*, 16 *Fordham J of Corp & Fin L* 125 (2011)

41 15 USC § 80a-17(f) (applicable to registered investment companies); 17 CFR § 270.17f-4

42 Letter from Dalia Blass, Director, Division of Investment Management, SEC, to Paul Schott Stevens, President and CEO, Investment Company Institute (18 January 2018), available at www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm

‘If larger institutional custodians begin to offer crypto-asset custody and the number of qualified custodians grows, the overall market for institutional investment products would potentially be able to grow and develop’

that are securities, or existing traditional mutual funds and ETFs could incorporate crypto-assets into their portfolios.

THE MARKET STATE OF CRYPTO-ASSET CUSTODY

Qualified custodians for crypto-assets do exist in the marketplace; there are a number of start-up custodians and small or ‘younger’ banks around the world that are trying to tackle the crypto-asset custody issue. In addition, several large institutional banks have shown curiosity about providing crypto-asset custodial services, and some have expressed a level of interest in providing custody services for crypto-assets.⁴³

If larger institutional custodians begin to offer crypto-asset custody and the number of qualified custodians grows, the overall market for institutional investment products would potentially be able to grow and develop. Best practices could evolve with the addition of responsible stewards of assets. Regulated entities such as funds or investment banks would be able to seek new investment opportunities, and regulated entities could become confident in their ability to meet their regulatory and fiduciary obligations to their customers. As highlighted by Blass in her letter, institutional custodians must solve key issues, such as those listed below, in order to adequately take custody of crypto-assets for regulated entities:

- validation of existence of the crypto-assets;
- exclusive ownership of the crypto-assets;

- software functionality of private keys; and
- maintenance of ownership records.

CONCLUSION

The quantity and complexity of crypto-assets continues to grow, along with institutional interest. For a variety of legal, reputational and scale reasons, many potential institutional investors, investment professionals and businesses find themselves forced to wait for the maturing of custody services for crypto-assets before making the leap. For many, such as investment advisers, investment funds and investment banks, one reason for their hesitation is that they require adequate custodial services to meet their own fiduciary obligations. As the trend towards asset tokenisation continues, so will the race to provide a greater supply of custodial services that can adequately handle crypto-assets in a way that meets commercial and regulatory demands. A larger supply of capable institutional custody services for crypto-assets would bring with it the possibility for more traditional financial products or services based on crypto-assets, help the markets and technologies mature and enable the evolution of existing and new offerings and portfolios that take advantage of the efficiencies and other benefits of blockchain.

JESSE KANACH IS A PARTNER,
DANA SYRACUSE IS SENIOR COUNSEL,
AND JOSHUA BOEHM AND THOMAS
AHMADIFAR ARE ASSOCIATES AT
PERKINS COIE⁴⁴

⁴³ Olga Kharif and Sonali Basak, *Regulated Crypto Custody Is (Almost) Here. It's a Game Changer*, Bloomberg, www.bloomberg.com/news/articles/2018-06-18/regulated-crypto-custody-is-almost-here-it-s-a-game-changer

⁴⁴ Starlin Shi, Summer Associate at Perkins Coie, also contributed to this article

GLOSSARY

Cold storage: Cold storage is the process of storing crypto-assets offline.

Digital wallet: A digital wallet is an electronic device or online service that is able to hold cryptocurrencies or tokens, and that can process electronic transactions.

Digital wallet provider: A digital wallet provider is a company or service that offers a digital wallet to either retail and/or institutional customers.

Futures commission merchant (FCM): A futures commission merchant is defined as an entity that solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps, and accepts money or other assets from customers to support such orders.

Hot storage: Hot storage is the process of storing crypto-assets online.

Multi-signature functionality: A governing structure with three strings made up of letters and numbers, called 'keys.' The three keys are the wallet key, the recovery key, and a key held by the wallet provider (the 'company key').

Multi-signature wallet: A multi-signature wallet creates addresses to store crypto-assets by requiring two out of the three multi-signature keys.

Private key: A private key is the code that gives the holder access to the asset at the address represented by the corresponding public key.

Public key: A public key is the 'address' where the digital asset is located on the network.