

## SEC Update on Crypto-Asset Safeguarding & Custody

In a recent [speech](#), SEC Chief Accountant Paul Munter discussed two fact patterns when a crypto-asset arrangement would not fall into the scope of Staff Accounting Bulletin (SAB) 121 and the use of distributed ledger/blockchain technology. This has allowed a major bank to offer clients custody for bitcoin and Ethereum without a balance sheet gross-up.

### Background

Staff Accounting Bulletin (SAB) No. 121 was published in March 2022 and expressed the SEC’s views on the accounting for the safeguarding of crypto assets that an entity holds for clients. SAB 121 requires reporting entities that perform crypto-asset safeguarding or custody activities to record a safeguarding liability with a corresponding crypto asset. This is a departure from the traditional off-balance-sheet treatment for custodied cash and securities. This accounting treatment and regulatory capital implications have deterred banks from providing crypto-asset custody services.

Munter highlighted conclusions from recent consultations where the SEC staff has determined that an entity has adequately addressed the risk and uncertainties, so that the arrangement is not within the scope of SAB 121 and no liability recognition is required.

*“... the staff’s conclusion was based on the specific facts, circumstances, representations, and warranties by the entity and its outside advisers, including in legal opinions, with respect to the entity’s arrangement. Those conclusions would not necessarily be the same for different fact patterns.” – Paul Munter*

### Bank Holding Companies

In this example, a regulated bank subsidiary was safeguarding crypto assets for only institutional customers. The bank held the cryptographic private key information that provides access to the crypto assets the bank was safeguarding.

- Prior to the consultation, the bank obtained written approval from its state prudential regulator after the regulator’s review of the governance and risk management practices for the planned activity. The bank also engaged with its primary federal prudential regulator, consistent with the regulator’s stated expectations.<sup>1</sup> The bank had comprehensive operational controls in place to mitigate risks associated with holding a private key for its customers’ blockchain wallets. The bank holding company affirmed that these controls and processes are subject to continuous supervision and oversight by the bank’s prudential regulators, including certain limitations on the types of customer crypto assets that can be safeguarded.
- The bank will hold its institutional customers’ crypto assets in a bankruptcy-remote manner. Each customer’s crypto assets will be held in a segregated individual blockchain wallet with the customer as the

<sup>1</sup> FDIC, [Notification of Engaging in Crypto-Related Activities](#); Federal Reserve Board, [Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations](#); Office of the Comptroller of the Currency, [Chief Counsel’s Interpretation Clarifying Authority of a Bank to Engage in Certain Cryptocurrency Activities](#).

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beneficial owner. This wallet is segregated from wallets that hold crypto assets for other customers or for the entity, and from other assets. The bank has entered into crypto-asset safeguarding contractual agreements with its institutional customers that limit the bank’s activities to holding and transferring crypto assets based on customer instructions, with no ability for the bank to use or otherwise rehypothecate its customers’ crypto assets.

- The bank holding company obtained a legal opinion from outside counsel supporting its “bankruptcy-remote” conclusion that based on the manner and legal structure in which the bank will safeguard the crypto assets, in the event of insolvency, the crypto assets should not be the property of the bank receivership estate and should not be available for distribution by the FDIC as receiver to the bank’s creditors.
- The bank negotiated with its institutional customers the contractual terms and conditions to be included in its crypto-asset safeguarding agreements that clearly set forth the standard of care the bank will be responsible for exercising and the scope of the bank’s liability, thereby mitigating risks that the bank will be exposed to liability for blockchain-specific risks that are outside the bank’s direct control.
- The bank holding company has a process for assessing regulatory, legal, and technological risks and uncertainties on an ongoing basis specific to each particular crypto asset the bank is considering safeguarding for its institutional customers.

The entity will provide disclosure in its SEC filings about the extent of crypto assets safeguarded and the relevant risk factors and impacts to risk management, as well as the significant judgments made in reaching its accounting policy conclusion.

## Introducing Broker-Dealers

In the second case presented, a registered broker-dealer engages in facilitating the purchase, sale, and holding of crypto assets by others, *i.e.*, an introducing broker-dealer. These registered introducing broker-dealers have generally entered into an arrangement with a third party (which may be an unaffiliated third party or an affiliate of the introducing broker-dealer) through which the third party will provide crypto-asset trade execution and safeguarding services for the introducing broker-dealer’s customers. In many of these arrangements, an interface allows the introducing broker-dealer’s customers to submit crypto-asset transaction orders and then transmits those transaction orders to the third party for fulfillment.

SEC staff would not object to a conclusion that, for the introducing broker-dealer, the arrangement is not within the scope of SAB 121 given the existence of the following facts and circumstances:

- **No Possession of the Cryptographic Key.** Neither the introducing broker-dealer, nor a person or entity acting as agent for the introducing broker-dealer, has rights to, or controls or possesses in any manner, the cryptographic private key information (or any part or portion of the information) necessary to transfer any crypto assets held by the third party on behalf of the customer.
- **The Third Party Is the Agent of the Customer.** The third party is the agent of the customer and does not act as an agent of the introducing broker-dealer for the safeguarding, transfer, or disposition of the crypto assets or customer funds the third party holds, and both the third party and the introducing broker-dealer acknowledge the absence of an agency relationship. In these consultations, the staff has found the combination of the following factors persuasive evidence that the third party is acting as the customer’s agent rather than the introducing broker-dealer:
  - The introducing broker-dealer has a written customer agreement that the broker-dealer will not serve as the customer’s agent for the safeguarding, transfer, or disposition of the crypto assets or funds held by the third party on behalf of the customer.

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- The introducing broker-dealer has clear and prominent disclosure, *e.g.*, in marketing materials or on customer interfaces, that safeguarding, transfer, or disposition services are provided by the third party and not by the broker-dealer or its agents.
- The third party treats the customer as a direct account holder and is solely responsible for providing account information, including statements and confirmations, directly to the customer for the crypto assets and funds the third party holds on the customer's behalf.
- The customer has a contractual relationship with the third party, whereby the customer has the legal authority and practical ability to transmit instructions directly to the third party (without broker-dealer intermediation) for the safeguarding, transfer, or disposition of any crypto assets or funds held by the third party on the customer's behalf, including instructions to move a crypto asset to another location or wallet outside of the third party's control, and to transfer funds derived from the sale of a crypto asset or otherwise held by the third party to the customer's bank account without any introducing broker-dealer involvement.
- The third party provides the customer with up-to-date information, *e.g.*, phone number, email address, or web portal, for the customer to contact the third party directly.
- The third party is responsible for resolving any customer complaints or disputes relating to the safeguarding, transfer, or disposition of the crypto assets or funds that the third party holds on the customer's behalf.
- The customer's crypto-asset account at the third party will continue to exist and the third party will continue to take customer instructions for the safeguarding, transfer, or disposition of the customer's crypto assets even if:
  - The customer closes its securities account at—or otherwise terminates its commercial relationship with—the introducing broker-dealer.
  - The introducing broker-dealer ceases to operate or is subject to a formal liquidation proceeding or receivership.
- **Legal Opinion.** The introducing broker-dealer obtains an opinion from outside legal counsel that supports the following assertions:
  - The third party is acting as the customer's agent and not the introducing broker-dealer for the safeguarding, transfer, or disposition of the crypto assets or funds the third party holds on the customer's behalf.
  - The broker-dealer has no contractual obligation under applicable law to compensate the customer for any loss arising from the third party's safeguarding, transfer, or disposition of crypto assets or funds it holds on the customer's behalf.
  - Crypto assets or funds that the third party holds on the customer's behalf would not be included in the estate of the broker-dealer if the broker-dealer were subject to a formal liquidation proceeding or receivership.

## Distributed Ledger Technology

The SEC has reviewed multiple consultations addressing the use of distributed ledger technology to track holdings and transfers of traditional financial assets that have been issued in “tokenized” form representing a bond or fractional share of a bond. Depending on specific facts and circumstances, the SEC would not object to an entity's conclusion that the arrangement was not within the scope of SAB 121; for example:

- Where the design of the distributed ledger technology system allows the transacting entity to control recording issuances and/or transfers of assets, including the ability for the entity to correct errors, if needed.

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- If transacting entities were able to attribute legal ownership of the traditional assets to their specific customers, which also can involve interoperability of the distributed ledger with traditional record-keeping systems that are maintained by the entity, e.g., reconciliation with customer databases and non-distributed ledger systems for customers to submit instructions to purchase, sell, or transfer their assets.

## What's Next?

Rumors that Bank of New York Mellon (BNY) was one of the bank holding company consultations were confirmed on September 16, 2024 in public testimony at a Wyoming's Select Committee on Blockchain, Financial Technology, and Digital Innovation Technology hearing.<sup>2</sup> This also was also confirmed by Bloomberg on September 26, when SEC Chair Gary Gensler suggested that BNY's crypto custody model could extend to numerous digital assets. Bloomberg estimates the crypto custody market at \$300 million with an annual growth rate of almost 30% and that crypto custody commands significantly higher fees than other asset classes.

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*“Though the actual consultation related to two crypto assets, the structure itself was not dependent on what the crypto was, it didn't matter what the crypto was,” – SEC Gary Gensler (Bloomberg)*

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Cryptocurrency custody arrangement opportunities have grown substantially since the January 2024 SEC approval of spot bitcoin exchange-traded funds (ETFs). TrackInsight reports that the 10 funds that offer this product have attracted \$52 billion in assets (mostly from retail investors) at the end of August 2024, while spot Ethereum ETFs accumulated more than \$7 billion.

## Conclusion

Despite the entry of BNY into the crypto custody market, the SEC's views on SAB 121 remain largely unchanged. The time, cost, and complexity to develop risk and compliance operations to meet these SEC expectations are significant. Forvis Mazars is here to help. If you have any questions or need assistance, please reach out to one of our professionals.

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<sup>2</sup> Wyoming's Special Purpose Depository Institution (SPDI) holds bank charters for Custodia and Kraken.

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