

Issues with Crypto Asset Custody and SEC Staff Accounting Bulletin No. 121

December 6, 2022

Policymakers must promptly take action to enhance the provision of independent custody services in crypto markets, as demonstrated by the recent failure of FTX and the associated misuse of customer funds.¹ However, to the contrary, recent accounting guidance by the Securities and Exchange Commission (the “SEC”), discourages the provision of independent custody services by prudentially regulated banks and registered broker-dealers. SEC Staff Accounting Bulletin 121 (“SAB 121”) does so by radically departing from existing accounting standards and requiring custodians of crypto assets to record an asset and liability on their balance sheets with respect to crypto assets. Doing so significantly increases the cost to banks and broker-dealers from providing custody services for crypto assets and thereby discourages them from doing so.

It is the view of the Committee on Capital Markets Regulation (the “Committee”) that banks and broker-dealers, which are principal providers of independent custody services for financial assets, are well-equipped to mitigate the risks that the SEC staff identifies in SAB 121 as necessitating a unique accounting treatment for crypto assets. We therefore call on the SEC to take swift action to exempt banks and broker-dealers from SAB 121 and thereby allow such custodians to exclude custodied crypto assets from their balance sheets, consistent with the approach that has traditionally applied to custodians of securities and derivatives.

Issues with Crypto Asset Custody

In securities and derivatives markets, exchanges do not take custody of customer assets.² Instead, other service providers such as investment advisers³ are generally required to place customer assets with qualified custodians (a “qualified custodian obligation”). Qualified custodians include FDIC-insured banks, registered broker-dealers, and certain state-chartered trust companies.⁴ Policymakers have however thus far not imposed a qualified custodian obligation on the digital trading platforms that allow users to trade crypto assets (“crypto exchanges”), which has permitted crypto exchanges to retain custody of their customers’ crypto assets.⁵ As a result, crypto exchanges hold custody of a considerable amount of customer assets. Though comprehensive data is not available, as one example, Coinbase reported that it held \$95.1 billion in customer crypto assets as of September 30, 2022.⁶

¹ See Hal Scott & John Gulliver, *An SEC Rule May Cost FTX Crypto Customers Billions* WALL STREET (Nov. 14, 2022), <https://www.wsj.com/articles/an-sec-rule-may-cost-ftx-customers-billions-trading-exchange-crypto-assets-broker-dealers-investors-markets-11668455906>.

² See, e.g., STATE STREET CORP., *Form 10-K*, 65 and 132 (Feb. 17, 2022), <https://investors.statestreet.com/filings-reports/sec-filings/sec-filings-details/default.aspx?FilingId=15581977>.

³ See 17 CFR § 275.206(4)-2.

⁴ See 17 CFR § 275.206(4)-2(d)(6).

⁵ See Chair Gary Gensler, *Prepared Remarks of Gary Gensler On Crypto Markets Penn Law Capital Markets Association Annual Conference*, U.S. SEC. & EXCH. COMM’N [“SEC”] (Apr. 4, 2022), <https://www.sec.gov/news/speech/gensler-remarks-crypto-markets-040422>.

⁶ See Coinbase Global, Inc., *Form 10-Q for the quarterly period ended September 30, 2022* 31 (Nov. 3, 2022), <https://investor.coinbase.com/financials/sec-filings/default.aspx>.

Crypto exchanges are not required to maintain the same level of safeguards with respect to custodied assets as qualified custodians. While crypto exchanges should be held to enhanced regulatory standards, implementing such a framework will take time, and banks and broker-dealers are best positioned to immediately address custody-related risks. For example, national banks acting as custodians must segregate custodial assets from the bank's assets and maintain accounting records and internal controls to verify compliance.⁷ Similar requirements apply to registered broker-dealers.⁸ State-chartered trust companies provide many of the same protections as federally chartered banks and registered broker-dealers and the provision of crypto asset custody services by such entities is preferable to custody by exchanges. However, federally chartered banks and registered broker-dealers provide an additional margin of safety because they are subject to special resolution regimes under federal law that are explicitly excluded from or supersede the Bankruptcy Code. Absent such standards, customers are at greater risk of loss arising from conflicts of interest relating to the potential misuse of customer funds, and the comingling of customer assets with exchange assets and the assets of other customers.⁹

A lack of appropriate custody protections can also put customers at increased risk of theft. There have been numerous instances of crypto exchange failures and thefts from crypto exchanges that have resulted in the loss of significant amounts of customer assets. For example, in 2021, \$14 billion in cryptocurrencies were stolen.¹⁰ The providers of traditional custodial services are subject to regulatory requirements and processes that can mitigate these risks. For example, banks are required to receive a notice of "non-objection" from the Office of the Comptroller of the Currency (the "OCC") regarding "risk management systems and controls" before conducting crypto-asset custody activities.¹¹ The Federal Reserve requires that its supervised banks notify it before engaging in crypto asset custody activities and justify the permissibility of those activities under the Bank Holding Company Act and other applicable legislation.¹² The Federal Deposit Insurance Corporation requires supervised institutions intending to provide crypto asset custody services to notify it in advance and provide information necessary for the FDIC to assess the risks related to those activities.¹³ SEC guidance would prevent a broker-dealer from taking custody of crypto assets if the broker-dealer is aware of any material security or operational problems or weaknesses in the technology used to access and transfer the customer's assets.¹⁴

⁷ SIFMA et al., Update on Efforts to Implement Staff Accounting Bulletin No. 121, 15 (Jun. 27, 2022), <https://www.sifma.org/wp-content/uploads/2022/06/SIFMA-ABA-SAB-121-Follow-Up-Letter-to-SEC.pdf> ["SIFMA Letter"].

⁸ SEC, Custody of Digital Asset Securities by Special Purpose Broker-Dealers, 86 FR 11627, 4-5 (2021) <https://www.federalregister.gov/documents/2021/02/26/2020-28847/custody-of-digital-asset-securities-by-special-purpose-broker-dealers>.

⁹ See TIMOTHY G. MASSAD, IT'S TIME TO STRENGTHEN THE REGULATION OF CRYPTO-ASSETS 16 (2019); DELOITTE, A MARKET OVERVIEW OF CUSTODY FOR DIGITAL ASSETS 7 (2020), https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/finance/me_Digital-Custodian-Whitepaper.pdf.

¹⁰ See, e.g., Gensler, *supra* note 5.

¹¹ See SIFMA Letter at 8, citing OCC Interpretive Letter 1170.

¹² Board of Governors of the Federal Reserve System, SR 22-6/CA 22-6: Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations (Aug. 16, 2022), <https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm>.

¹³ Federal Deposit Insurance Corporation, Notification of Engaging in Crypto-Related Activities (Apr. 7, 2022), <https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html>.

¹⁴ See SEC *supra* note 8.

Moreover, the combination of exchange and custodian functions can place customers at greater risk of loss of their assets and private data. First, certain crypto exchanges hold crypto assets for their own account,¹⁵ which may place them at greater risk of financial distress, and thus place customers at greater risk of loss of assets custodied by the exchange, especially given the recent downturn in crypto asset markets.¹⁶ Second, exchanges are not subject to capital, liquidity, and stress testing requirements to which banks are subject, and which mitigate the risk of a bank custodian experiencing financial distress. More fundamentally, failure to properly custody a customer's assets risks subjecting the customer's assets to the claims of the custodian's other creditors in an insolvency proceeding.

The recent Chapter 11 bankruptcies of crypto trading platforms Voyager and FTX illustrate these risks. In the case of Voyager, customers' USD funds on deposit, which were held by an independent FDIC-insured bank custodian, were expected to be returned to customers, whereas customers were expected to receive only a fraction of their crypto assets, which Voyager custodied directly.¹⁷ In the case of FTX, billions of dollars of customer assets appear to have been loaned to an affiliated proprietary trading firm without customers' knowledge. When substantial losses at the trading firm forced FTX to file for bankruptcy, a lack of internal controls and security protocols resulted in an estimated \$372 million in unauthorized withdrawals¹⁸ and a potential loss of \$288 million of assets from a hack.¹⁹ It remains unclear how much, if any, of the \$16 billion dollars of customer assets held by FTX will be returned to customers.

The provision of custody services by banks and broker-dealers would shield customers from these risks. However, rather than encouraging the provision of independent, qualified custody services for crypto assets, recent SEC guidance has had the opposite effect.

¹⁵ See COINBASE GLOBAL, INC., *Form 10-K* (Dec. 31, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1679788/000167978822000031/coin-20211231.htm#i829f555acdba4aa89c9118e2d6ff7b52_1498 (showing \$566.5 million in crypto assets held for investment and operational purposes).

¹⁶ See Adam Levitin, *What Happens If a Cryptocurrency Exchange Files for Bankruptcy*, CREDIT SLIPS (Feb. 2, 2022, 11:06pm), <https://www.creditslips.org/creditslips/2022/02/what-happens-if-a-cryptocurrency-exchange-files-for-bankruptcy.html>.

¹⁷ See Voyager Digital, Ltd., Customer Agreement, Section 5 <https://www.investvoyager.com/useragreement/> (last visited July 18, 2022); Soma Biswas, *Crypto Firm Voyager Seeks to Honor Customer Withdrawals From Custodian Bank*, WALL STREET JOURNAL (July 15, 2022) <https://www.wsj.com/articles/crypto-firm-voyager-seeks-to-honor-customer-withdrawals-from-custodian-bank-11657922435>; Eliot Brown, *Crypto Broker Voyager Digital Files for Bankruptcy Protection*, WALL STREET JOURNAL (July 6, 2022) https://www.wsj.com/articles/crypto-broker-voyager-digital-files-for-bankruptcy-protection-11657098630?mod=article_inline.

¹⁸ In re FTX Trading Ltd., Declaration of John J. Ray III in Support of Chapter 11 Petitions and First Day Pleadings, United States Bankruptcy Court for the District of Delaware, Case No. 22-11068 (JTD) <https://pcl.uscourts.gov/pcl/pages/search/results/cases.jsf?sid=a3a86e0b27864934b7a2bc169f353323>.

¹⁹ Martin Young, *FTX Hacker is now the 35th largest hf ETH*, COINTELEGRAPH (Nov. 16, 2022), <https://cointelegraph.com/news/ftx-hacker-is-now-the-35th-largest-holder-of-eth>

SEC Staff Accounting Bulletin No. 121

Custodians have traditionally not recorded custody obligations with respect to client assets such as securities and derivatives on their balance sheets, based on legal precedent providing that these assets are not subject to the claims of the custodian's creditors in the event of bankruptcy.²⁰ Relying on the same precedent, custodians of crypto assets had, until recently, not recorded those assets and corresponding safeguarding obligations on their balance sheets as assets and liabilities.²¹ However, on March 31, 2022, the staff of the SEC published an accounting bulletin ("**SAB 121**") indicating that, for periods ending after June 15, 2022, the custodians of crypto assets should record an asset and liability on their balance sheets with respect to the custodied assets and corresponding safeguarding obligations, in each case equal to the fair value of the custodied crypto assets.²²

SAB 121 suggests that its departure from the traditional approach to accounting for custodied assets arises from the heightened theft risks and legal uncertainties associated with crypto assets, including uncertainty as to the treatment of custodied crypto assets under bankruptcy law, which it asserts gives rise to "significant risks" associated with safeguarding such assets.²³ Recording the custodian's safeguarding obligation as a liability on the balance sheet is thus presumably intended to alert the custodian's investors to the increased risks of loss, theft, and legal liability associated with holding crypto assets as compared to more traditional financial assets at a qualified custodian. However, SAB 121's rationale constitutes a significant and inexplicable departure from the principles that inform standards for accounting for loss contingencies. Under the existing standard (ASC 450) the presence of a risk of loss requires recording a liability on the balance sheet only if the loss is "probable," which is generally considered to mean a 75% or greater likelihood, and "reasonably estimable."²⁴ SAB 121 would require that certain contingent losses be recorded regardless of whether they meet either such criterion merely because the risk of loss, no matter how remote or inestimable, relates to crypto assets.

SAB 121 applies to crypto exchanges and to any agent acting on behalf of such a business in safeguarding users' crypto assets that is publicly offered. SAB 121 would thus require any such entity, including a public independent custody provider such as a bank or broker-dealer, to account for custodied crypto assets on its balance sheet.

²⁰ Paul Kiernan, *SEC Tells Exchanges to Treat Customer Crypto Holdings as Liabilities*, WALL STREET JOURNAL (Mar. 31, 2022), https://www.wsj.com/articles/sec-tells-exchanges-to-treat-customer-crypto-holdings-as-liabilities-11648743902?mod=article_inline.

²¹ *Id.*

²² See SEC, *Staff Accounting Bulletin No. 121* (modified Apr. 8, 2022), <https://www.sec.gov/oca/staff-accounting-bulletin-121> [**SAB 121**]; see also Paul Kiernan, *supra* note 20; Soyoungh Ho, *New SEC Staff Guidance Covers Platform Accounting for Crypto-Asset Safeguards*, THOMSON REUTERS (Apr. 6, 2022), <https://tax.thomsonreuters.com/news/new-sec-staff-guidance-covers-platform-accounting-for-crypto-asset-safeguards/>.

²³ See SAB 121.

²⁴ PwC, *US Financial statement presentation guide 23.4, Contingencies* (updated Apr. 30, 2022), https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/financial_statement_/financial_statement___18_US/chapter_23_commitmen_US/234_contingencies_US.html.

Prior to the implementation of SAB 121, crypto exchanges had been increasingly making use of independent custody services, and banks were beginning to offer such services for crypto assets.²⁵ However, SAB 121 undermined this desirable development by requiring independent custodians to account for custodied crypto assets in a manner that significantly expands the custodian's balance sheet. SAB 121 would particularly disincentivize the provision of independent custody services to crypto exchanges by banking institutions and broker-dealers, as these entities are subject to higher capital and liquidity requirements when their balance sheets increase in size.²⁶ Nonetheless, one of the two largest providers of custody services for traditional financial assets, BNY Mellon, introduced a crypto asset custody service in October 2022. However, BNY Mellon reports that SAB 121 limits its ability to provide this service at a large scale.²⁷ Although the availability of qualified custody services does not itself prevent an exchange such as FTX from continuing to hold and misuse customer assets, it would increase competitive pressure and public scrutiny for exchanges that fail to employ such services. SAB 121 thus prevents a potential market solution to the issue of crypto asset custody.

The Acting Chief Accountant of the SEC recently suggested that banking regulators could address the effects of SAB 121 on banks and affiliated broker-dealers that custody crypto assets by “adjusting GAAP information” as “information that is necessary and useful for investors may be unnecessary to include in a bank’s regulatory capital calculation.”²⁸ Such an adjustment would presumably entail ignoring entries on a bank’s balance sheet that are attributable to crypto asset custody activities to lower the applicable capital requirements. However, deviating from GAAP for the purpose of calculating bank capital requirements would require careful consideration from banking regulators. It would also be potentially impeded by the provision of the Federal Deposit Insurance Act that provides that any non-GAAP accounting principles applicable to FDIC-insured depository institutions must be “no less stringent” than GAAP.²⁹ This approach would thus potentially necessitate an additional layer of regulatory and legislative complexity.

Risk Mitigation by Bank and Broker-Dealer Custodians

SAB 121 asserts that the safeguarding of crypto assets involves unique technological, regulatory, and legal risks that are not present in the safeguarding of non-crypto assets, and which justify the inclusion of an asset and liability on the custodian’s balance sheet with respect to custodied crypto assets.

²⁵ See, e.g., Rachel Wolfson, *Future of finance: US banks partner with crypto custodians* COINTELEGRAPH (Feb. 20, 2022), <https://cointelegraph.com/news/future-of-finance-us-banks-partner-with-crypto-custodians>; USBANK, *Cryptocurrency custody: 6 frequently asked questions* (Dec. 15, 2021), <https://www.usbank.com/financialiq/plan-your-growth/find-partners/cryptocurrency-custody-6-frequently-asked-questions.html>.

²⁶ SIFMA et al., *Letter to the SEC re: Request for Deferral of Effective Date of Staff Accounting Bulletin No. 121* (May 27, 2022), <https://www.aba.com/-/media/documents/comment-letter/joint-letter-to-sec-on-sab-121-05272022.pdf?rev=d834517811874090af3b6496e5f3330c>.

²⁷ See Yueqi Yang, *Wall Street Courts Crypto Custody, But with Fingers Crossed*, BLOOMBERG (Oct. 27, 2022), <https://www.bloomberg.com/news/newsletters/2022-10-27/bny-mellon-bk-state-street-stt-court-crypto-custody-with-fingers-crossed?sref=2ICQoM0A>.

²⁸ Paul Munter, *SEC Chief Accountant Replies on FTX Crash*, WALL STREET JOURNAL (Nov. 18, 2022), <https://www.wsj.com/articles/sec-chief-accountant-ftx-crypto-crash-regulation-rule-guidance-11668724515>.

²⁹ Federal Deposit Insurance Act, Section 37(a)(2)(B).

SAB 121 cites as risks: (1) the risk of theft or loss of asset keys, (2) greater uncertainty in the legal treatment of custodied crypto assets in the event of bankruptcy, and (3) a relative lack of regulatory requirements governing the safeguarding of such assets. However, banking organizations have operational capabilities, regulatory obligations, and a unique legal status that mitigate these risks.³⁰ For example, with regard to legal risks, a combination of UCC provisions, regulatory and supervisory guidance, and bank-specific court precedent ensure that custodial assets will not be treated as assets of an insolvent bank custodian.³¹ And the SEC has already issued guidance applying the custodial standards required of registered broker-dealers, including the customer-protection rule, to broker-dealers that custody crypto asset securities.³² Because assets held by bank or broker-dealer custodians are not subject to claims of their general creditors, there is no basis for treating them as assets of those custodial entities. Moreover, insofar as those entities face possible, contingent risks of loss regarding their custodial assets, ASC 450 is the applicable accounting standard for whether those risks require recording of a liability, and its test for doing so—probability of incurrence and a reasonably estimable amount—would not be met in this case. Thus, even if there are risks unique to the custody of crypto assets, it does not follow, at least in the case of bank or broker-dealer custodians, that the SEC should mandate the recording of a balance sheet item to reflect those risks. Rather, the SEC should require appropriate disclosure of those risks by custodians of crypto assets.

Recommendation

Policymakers should seek to facilitate rather than discourage the provision of independent custody services in the crypto market. The SEC should therefore immediately exempt prudentially regulated banks and registered broker-dealers from SAB 121. The Committee would also support the establishment of a qualified custodian obligation for crypto assets similar to what currently applies to traditional securities and derivatives.

³⁰ See SIFMA Letter.

³¹ See *id.* at 12; see also, David Lopez et al., *A custodial analysis of staking*, BLOCKCHAIN & CRYPTOCURRENCY REGULATION 5th ed. (2023).

³² See *id.* at 21; SEC, *supra* note 7 at 11,628.