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CRYPTO ASSET CUSTODY BY INVESTMENT ADVISERS AFTER THE SEC'S PROPOSED SAFEGUARDING RULE

Abstract: The Custody Rule under the Advisers' Act requires registered investment advisers to custody client funds and securities with a clearly defined set of "qualified custodians." Few such qualified custodians exist for crypto assets, and crypto assets have several characteristics that distinguish them from traditional securities — these unique characteristics often pose distinct challenges for traditional custodians. We briefly examine the evolution of, and the principles underlying the Custody Rule under the Advisers Act, and the SEC's proposed new Safeguarding Rule to suggest that instead of requiring investment advisers to custody crypto assets with qualified custodians, investment advisers should be permitted to self-custody crypto assets, provided their custody fulfills certain specified criteria.

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THE CRYPTO-CUSTODY PROBLEM AND THE SAFEGUARDING RULE

Custody continues to be the single greatest question facing crypto market participants. Although it is too early to definitively declare what caused the recent and remarkable fall of FTX, it appears likely that weaknesses in custodial arrangements may have played a part.¹ Nor is FTX an isolated instance. A recent Chainalysis report

found that through July 2022, \$1.9 billion worth of crypto assets² were stolen in hacks of services, compared to just under \$1.2 billion at the same point in 2021.³

¹ *FTX Violated Its Own Terms of Service and Misused User Funds, Lawyers Say*, (Nov. 10, 2022), available at <https://www.coindesk.com/policy/2022/11/10/ftx-violated-its-own-terms-of-service-and-misused-user-funds-lawyers-say/>.

² For purposes of this essay, the term "crypto asset" is used in the identical sense the SEC refers to a "digital asset," i.e., it refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

³ Eric Jardine (Chainalysis), *Mid-Year Crypto Crime Update: Illicit Activity Falls With Rest of Market, With Some Notable Exceptions* (Aug. 16, 2022) available at <https://blog.chainalysis.com/reports/crypto-crime-midyear-update-2022/>.

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