August 16, 2018
Why Blockchain Custody Is So Difficult—The Simple Part

"*There are no easy answers, but there are simple answers*."—President Reagan In a [January 2018 letter](#) to the ICI and SIFMA, Director Dalia Blass of the SEC's Division of Investment Management posed the following question, among many others:

> To the extent a fund plans to hold cryptocurrency directly, how would it satisfy the custody requirements of the 1940 Act and relevant rules?"

There is a simple answer to this: "Just like our custodian satisfies these requirements with respect to most other financial assets held in our securities account." But structural differences between cryptocurrencies and more traditional financial assets may make this harder than it sounds.

Custody Through Security Entitlements

As reflected by [Rule 17f-4](#) under the Investment Company Act of 1940, the custody of securities cleared through [The Depository Trust Company](#) or other U.S. registered clearing agencies, or through the [Fedwire Securities Service](#), is maintained through security entitlements in securities accounts established in accordance with [Article 8](#) of the Uniform Commercial Code. This includes most of the assets held by U.S. registered investment companies. Thus, if a custodian can create a security entitlement to a cryptocurrency, it will maintain custody of the cryptocurrency in exactly the same way as it maintains custody of most of a fund's other assets.

Treating Cryptocurrencies as Financial Assets

We and others have been pointing out for some time [the potential application of Article 8 to blockchain assets](#). When Article 8 was revised in 1994, the term "financial asset" was "defined to include not only securities but also a broader category of obligations, shares, participations, and interests." Indeed, "financial asset" ["is defined broadly enough so that any asset in a security account is subject to the rules on securities entitlements."](#) Thus, the definition of a [financial asset](#) includes:

> any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article."

A custodian is a "securities intermediary" for purposes of Article 8, and holds a financial asset for another person when the custodian "[indicates by book entry that a financial asset has been credited to the person's securities account](#)." We have seen custodians rely on this approach to establish custody over foreign currency held in offshore bank accounts. When a custodian cannot open foreign bank accounts in their clients' names, it opens a single client account in the custodian's name. Although foreign currency is not a "security" as defined by Article 8, the custody agreement provides that the foreign currency held in such sub-custodial bank accounts will be treated as "financial assets." This allows the custodian to use the same book-entry system to record each client's ownership of the foreign currency as it does to record ownership of securities. We see no reasons this should not work under Article 8 for cryptocurrency as well.

Maintaining Custody of Cryptocurrency

UCC Section [8-504](#) requires a securities intermediary to "promptly obtain and thereafter maintain a financial

asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to that financial asset." This means that a custodian must be able to maintain any cryptocurrency it credits to a client's securities account. As explained in a previous [article](), cryptocurrency is held in a "wallet" which corresponds to a combination of public and private "keys" required to transfer units on the blockchain. If the custodian creates a wallet over which it exercises exclusive control via its private key, then it can use the wallet to obtain and maintain cryptocurrency corresponding to its customer's security entitlements. The wallet would give the custodian direct ownership of the cryptocurrency. A distributed ledger does not operate like a clearing corporation, with the security held by the clearing corporation, which creates security entitlements for its members, which create security entitlements in turn for their customers. The distributed ledger on a blockchain provides a record of how much of the cryptocurrency relates to each public key. The distributed ledger is more analogous to a transfer agent or recorder of deeds than to a clearing corporation. Because the custodian would hold the cryptocurrency directly, the security entitlement to cryptocurrency should not need to comply with Rule 17f-4. Our next post will examine some of the practical difficulties of this form of custody for cryptocurrencies.

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