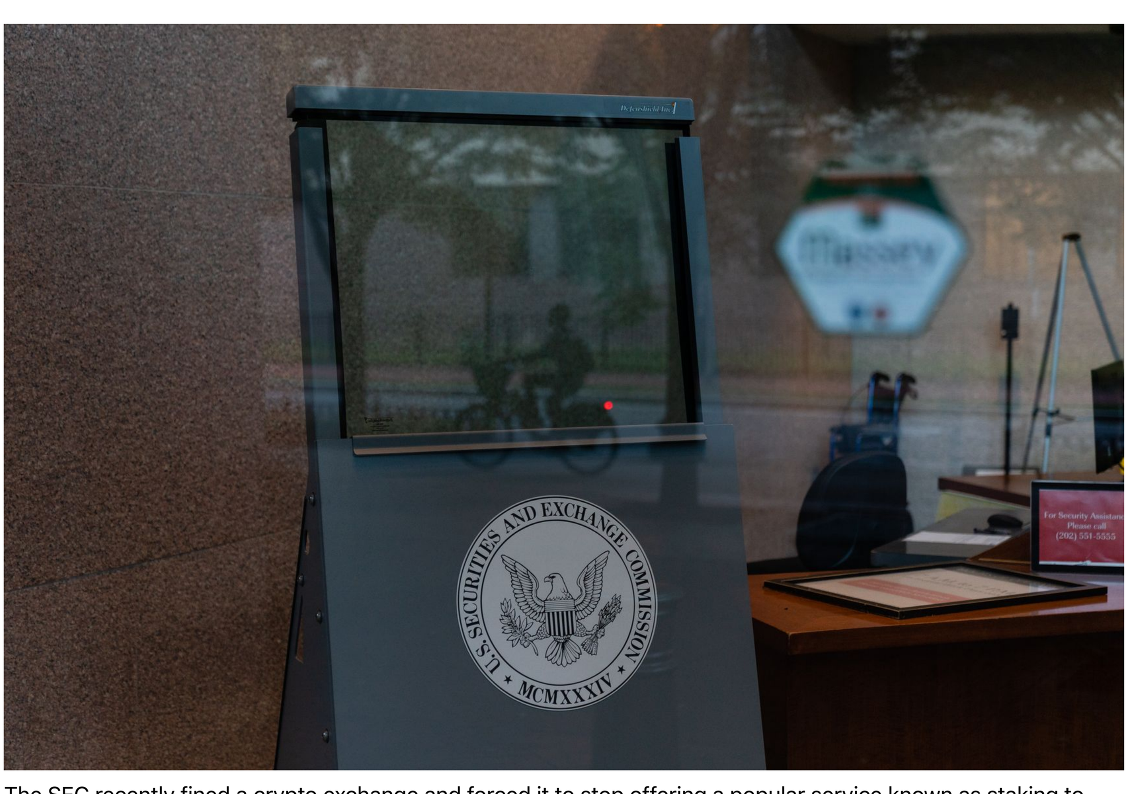
MARKETS | FINANCIAL REGULATION

SEC Proposes Rule That Could Squeeze Crypto Platforms

Proposal would impose heightened standards on entities that hedge, pension funds use to hold customer assets



The SEC recently fined a crypto exchange and forced it to stop offering a popular service known as staking to U.S. investors.
PHOTO: ERIC LEE FOR THE WALL STREET JOURNAL

By Paul Kiernan Follow and Justin Baer Follow
Updated Feb. 15, 2023 5:26 pm ET

Your WSJ Bundle News
Personalize Your Experience More Stories
Crypto Giant Binance Expects to Pay Penalties to Resolve U.S. Investigations
The Wall Street Journal 23 minutes ago
Cisco gear getting into Russia is 'disappointing' and 'frustrating,' exec says
MarketWatch 24 minutes ago
AMC Networks names Kristin Dolan its new CEO
MarketWatch 37 minutes ago
Top 5 China Stocks To Buy And Watch: Several Flirt With Entries
Investor Business Daily 1 hour ago
Opinion: The FBI's Catholic Canard
The Wall Street Journal 1 hour ago
'La Cartonería Mexicana | The Mexican Art of Paper and Paste' Review: Festive Figures
The Wall Street Journal 1 hour ago

Wall Street's regulator proposed a rule that could make it more difficult for many asset managers to invest customers' money in cryptocurrencies, as policy makers push to rein in the sector following trading platform FTX's collapse.

The Securities and Exchange Commission voted 4-1 Wednesday on a proposal that would expand the types of assets that investment advisers, such as hedge funds and pension funds, are required to hold using qualified custodians.

The proposal would also create new requirements for qualified custodians and notes that certain features of cryptocurrencies could make them difficult to safeguard in compliance with the rules. The proposal would limit how asset managers can handle customers' crypto assets but wouldn't impose new requirements on individual investors who manage their own portfolios.

Qualified custodians traditionally include banks, trust companies and broker-dealers. But the idiosyncrasies of keeping assets such as bitcoin safe from theft or hacks have in recent years led Coinbase Global Inc. and similar crypto platforms to start offering the service.

"It's going to make advisers jump through more hoops to invest in crypto," Jay Baris, a partner at Sidley Austin LLP's asset-management practice, said of the SEC's proposed requirements.

SEC Chair Gary Gensler has repeatedly said that crypto firms' custody practices might not clear the legal hurdles necessary to keep their customers' assets safe in the event of a bankruptcy.

"The current business model in crypto exchanges does not meet the qualified custodial standard," Mr. Gensler said after the vote.

He noted that investment advisers have already lost money in the bankruptcies of Celsius Network LLC, Voyager Digital Ltd. and FTX because those firms commingled customer assets with their own.

Coinbase's website says thousands of institutional customers use its Prime platform to safeguard their assets and says it is a qualified custodian. The firm reported $68.4 million in fees from its custodial services in the first nine months of 2022, down 21% from a year earlier.

Paul Grewal, Coinbase's chief legal officer, said the firm is confident that its New York-chartered trust entity "will remain a qualified custodian."

SHARE YOUR THOUGHTS

Should the SEC restrict the ability of investment advisers to hold crypto for their customers? Why or why not? Join the conversation below.

In its SEC disclosures, Coinbase says that in the event of a bankruptcy, customers whose crypto assets the firm custodies "could be treated as our general unsecured creditors."

Hester Peirce, the only SEC commissioner to vote against the proposal, said it could shrink the number of qualified custodians for crypto assets. "We could leave investors in crypto assets more vulnerable to theft or fraud, not less," she said.

Prices of crypto stocks and currencies jumped in tandem on Wednesday, suggesting that investors had been bracing for tougher rules, such as banning state-chartered trusts that crypto firms currently use to safeguard assets from being qualified custodians.

The SEC proposed the rule at the same time that it and other regulators are cutting off access to some products and services central to the digital-currency business. The SEC recently fined a crypto exchange, Kraken, and forced it to stop offering a popular service known as staking to U.S. investors. It notified another crypto firm, Paxos Trust Co., of a possible enforcement action related to a dollar-pegged cryptocurrency the firm issues. In January, the Federal Reserve warned banks against getting deeply involved in crypto.

Platforms operating in the U.S., such as Coinbase, have tried to avoid regulation by the SEC, arguing that the digital tokens they allow investors to buy and sell, as well as those that they custody, don't meet the definition of securities. That is a significant point of disagreement with Mr. Gensler, who has said that the vast majority of crypto tokens are securities.

"There's far too much noncompliance in this field," he said Wednesday.

Crypto imploded in 2022, as investors lost faith in digital assets and the industry was plagued with crisis. But unlike other collapses, it has largely avoided rippling into other markets. WSJ explains how crypto became so interconnected. Illustration: Mallory Brangan

Under decades-old regulations, investment advisers are usually required to keep their customers' funds and securities with a qualified custodian. Some crypto platforms have argued that those custody regulations don't apply to them.

The rule proposed Wednesday would expand the qualified-custodian requirements to include virtually any assets that an adviser might hold in a client's name—including all cryptocurrencies and even some physical assets such as artwork.

"There has been a lot of concern about how secure these assets are," said Kevin O'Brien, a partner at Ford O'Brien Landy LLP and a former federal prosecutor.

Cryptocurrencies are often transferable by anyone who holds a "private key." Because of that, the SEC's proposal says, it may be more difficult for a custodian to demonstrate that it has exclusive control of crypto than of traditional assets like stocks and bonds.

Several custody-firm executives said they expect the proposed rules would eventually add new requirements for what it means to be an authorized custodian. Some existing providers may opt not to remain in the business, they predicted.

They also said the SEC's proposal could encourage investment firms to entrust their crypto assets to mainstream banks, even as bank regulators are scrutinizing crypto activities.

Republican SEC Commissioner Mark Uyeda said the proposal raises questions about whether an investment adviser looking to offer crypto could ever satisfy the regulatory requirements.

"This approach to custody appears to mask a policy decision to block access to crypto as an asset class," Mr. Uyeda said. Nevertheless, he praised the decision to advance crypto policy via rule making rather than enforcement actions, and voted to support the proposal.

The proposal will be open to public comment for at least two months before staff begin work on a final rule.

SEC commissioners also voted to adopt an unrelated rule in response to the GameStop Corp. trading frenzy of early 2021.

That rule requires Wall Street firms to reduce the time it takes to settle most securities trades to one business day from two. Known as "T+1 settlement," the change would reduce the amount of collateral that brokerages must post at the stock market's clearinghouse to protect against the risk of other firms defaulting.

That could reduce the likelihood of a repeat of Jan. 28, 2021, when Robinhood Markets Inc. limited customers' ability to purchase more GameStop shares after receiving a $3 billion margin call from the clearinghouse.

Under the rule approved Wednesday, firms will need to implement the faster process on May 28, 2024. That gives Wall Street a few more months to prepare for the change than the SEC had originally proposed last year.

Kenneth Bentsen, CEO of the Securities Industry and Financial Markets Association, an industry lobby group, said it would have been better to push the change to Labor Day weekend in 2024.

"It is the industry, and not the regulators, who will do the work to shorten the cycle, and rushing the implementation for no apparent reason will only add risk when the underlying goal is to mitigate risk," he said.

Broker-dealers and other firms say they expect the shift to T+1 to be a heavy lift because of the complexity of upgrading numerous interconnected systems.

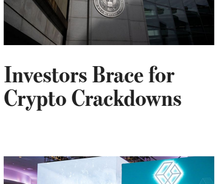
—Alexander Osipovich contributed to this article.

Write to Paul Kiernan at paul.kiernan@wsj.com and Justin Baer at justin.baer@wsj.com

The Effects of FTX

Coverage of the crypto market and the exchange's bankruptcy, selected by editors

SIGN UP FOR THE WSJ CRYPTO NEWSLETTER


Your Guide to FTX and the Crypto Crash

Investors Brace for Crypto Crackdowns

How a Tiny Farming-Town Bank Got Tied Up With FTX

Celebrities Who Endorsed Crypto, NFTs Face Lawsuits

How Sam Bankman-Fried's Psychiatrist Became an FTX Player

Bitcoin Fund Investors Pay the Price

A Crypto Magnate Saw the Risks and Still Was Hammered

Crypto Crisis: A Timeline of Key Events

Appeared in the February 16, 2023, print edition as 'SEC Moves to Tighten Rules For Advisers Handling Crypto'.

SHOW CONVERSATION (24)