

# Recent Disclosure Guidance Highlights Growing Concern Surrounding the Risks of User Assets Held by Various Crypto Custodians

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Recent turmoil in the cryptocurrency market has brought issues related to crypto-asset custody to the forefront of the cryptocurrency discourse;<sup>1</sup> in an enormous \$1 trillion crypto-asset crash between approximately May 6, 2022 and May 16, 2022, some coins lost up to 99% of their original value.<sup>2</sup> Many crypto-asset investors are now wondering how their assets may be treated if their crypto-asset exchange of choice were to file for bankruptcy.<sup>3</sup> While this question remains largely unanswered, new guidelines issued on April 11, 2022 by the U.S. Securities Exchange Commission (the “SEC”) regarding platforms that safeguard or hold crypto-assets on behalf of users may require additional disclosures on this topic.

**SEC Guidance for Crypto-Asset Custody Disclosures.** The SEC’s new Staff Accounting Bulletin (“SAB 121”) added interpretive guidance “for entities to consider when they have obligations to safeguard crypto-assets for their platform users.”<sup>4</sup> This bulletin addresses three main risk concerns surrounding crypto custodians:<sup>5</sup> (1) technological risks, particularly with respect to the safeguarding of customer assets and information; (2) legal risks that arise due to the unique character and lack of legal precedent with respect to crypto-assets; and (3) regulatory risks, as there are no current clear regulations for crypto-asset trading and custody.

SAB 121 states that crypto-asset custodians should make several key disclosures to better inform its platform users of the various risks involved, including:

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<sup>1</sup> James Nani, “If a Crypto Exchange Goes Bankrupt, What Happens?: Explained,” *Bloomberg* (May 19, 2022), available at <https://news.bloomberglaw.com/bankruptcy-law/if-a-crypto-exchange-goes-bankrupt-what-happens-explained>.

<sup>2</sup> See, e.g., Byungkwon Lim & Amy Aixi Zhang, “Part 1: Luna, UST and the Future of Stablecoin,” *Debevoise & Plimpton Fintech Blog* (May 16, 2022), available at <https://www.debevoisefintechblog.com/2022/05/16/luna-ust-and-the-future-of-stablecoin/>.

<sup>3</sup> For the purposes of this article, we will assume that such crypto-asset exchanges would qualify to be debtors under Section 109 of the Bankruptcy Code.

<sup>4</sup> Staff Accounting Bulletin, 17 CFR 211.121 (2022).

<sup>5</sup> The term “crypto custody” is used to describe the process of securing digital assets from theft through the use of third parties who act as safeguards of a user’s assets (e.g., cash, securities or virtual assets). See Krisztian Sandor, “What is Crypto Custody?,” *CoinDesk* (Feb. 18, 2022), available at <https://www.coindesk.com/learn/what-is-crypto-custody/>.

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- The nature and amount of crypto-assets that an entity is responsible for holding for its platform users;
  - The fair value measurements of crypto-assets;
  - Who owns the crypto key information, maintains recordkeeping of crypto-assets and is obligated to protect crypto-assets;
  - Significant risks and uncertainties associated with an entity's holding crypto-assets for platform users;
  - The potential impact that the loss of cryptographic key information would have on an entity; and
  - The risk mitigation steps an entity has taken in light of the concerns mentioned in SAB 121.<sup>6</sup>

The guidelines set by SAB 121 are intended to inform the public about the uncertainties surrounding crypto-assets in custodial possession on various crypto-asset exchanges. Pursuant to these guidelines, popular crypto-asset exchange platforms must now disclose specific risks related to their custody of user assets in filings going forward.<sup>7</sup>

**Liquidation of Crypto-Asset Exchanges.** In a recent filing, one exchange explained that custodial-held crypto-assets may be considered property of a bankruptcy estate and, thus, in the event of a bankruptcy, crypto-assets held by the exchange on behalf of customers could be subject to bankruptcy proceedings. In such an event, customers may be treated as general unsecured creditors.<sup>8</sup>

With respect to potential liquidation, there are potential differences between securities held by customers at SEC-registered broker-dealers and digital assets held by crypto-exchanges. Liquidations of registered broker-dealers are overseen by the Securities Investor Protection Corporation ("SIPC") under the Securities Investor Protection Act ("SIPA"). With liquidations overseen by SIPC, customer accounts are segregated from those of the brokerage's assets, meaning that customer assets cannot be used to satisfy debts of other creditors in bankruptcy proceedings.<sup>9</sup> Since most crypto-exchange

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<sup>6</sup> 17 CFR 211.121.

<sup>7</sup> See Coinbase 10-Q at 83.

<sup>8</sup> See [Twitter.com/brian\\_armstrong](https://twitter.com/brian_armstrong).

<sup>9</sup> Under the Bankruptcy Code, a trustee must convert held securities to cash and distribute that cash to customers. 11 U.S.C. 748. Whereas, under SIPA, the customer's held securities are transferred back to the customer in the event of a SIPA proceeding. See U.S. Courts, available at <https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/securities-investor-protection-act-sipa> (last visited May 17, 2022).

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platforms are not registered broker-dealers or members of a securities exchange, their bankruptcies would not be overseen by SIPC; instead, these crypto-asset exchange platforms would be liquidated under the Bankruptcy Code.

**Bankruptcy Considerations.** If a crypto-asset exchange were to be liquidated under the Bankruptcy Code, the digital assets that are held on the crypto-asset exchange on behalf of its platform users could, under certain circumstances, be viewed by a bankruptcy court as the crypto-asset exchange's corporate assets in a bankruptcy proceeding. In such an event, customers may be treated as unsecured creditors and, thus, potentially stand to lose some or all of the value of their investment in the crypto-assets.

Under the Bankruptcy Code, all of a debtor's assets and interests become property of the debtor's "estate,"<sup>10</sup> which is generally available for distribution to the debtor's creditors in accordance with the priorities set forth in the Bankruptcy Code. The question as to what assets constitute property of the debtor's estate is not answered by the Bankruptcy Code. Rather, the nature of a debtor's interest in a particular item of property is generally determined by applicable non-bankruptcy law. However, Congress intended for property of the estate to be viewed broadly, and the Bankruptcy Code provides that property of the estate includes assets "wherever located and by whomever held."<sup>11</sup>

While property of the debtor's estate is defined broadly, the Bankruptcy Code explicitly excludes any property in which a debtor holds only legal title and not an equitable interest, such as assets held by the debtor under trust, escrow, agency or bailment arrangements.<sup>12</sup> Accordingly, it will be a fact-based determination whether a customer's crypto-assets are property of the debtor, or whether they remain the customer's property under applicable non-bankruptcy law. Key factors that courts would likely consider in making this evaluation include: 1) the intent of the parties, as reflected in, for example, the terms of any custodial or other agreements that exist between the customer and the crypto-exchange; 2) whether the assets are commingled with the debtor's assets or can be readily traced and identified; and 3) the debtor's control over such assets. Accordingly, the specific factual arrangement governing the crypto-assets will be critical in determining whether a court would view such assets as part of the debtor's estate that could be used to satisfy the claims of general creditors (to the detriment of the individual customer), and such determination may not be the same for all customers of a specific exchange.

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<sup>10</sup> 11 U.S.C. § 541(a).

<sup>11</sup> *Id.*

<sup>12</sup> 11 U.S.C. § 541(d). *See also United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.10 (1983) ("Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition.").

**Implications.** Policymakers have increasingly focused on crypto-asset custody; for example, SEC Chairman Gary Gensler has repeatedly warned that investors who own cryptocurrency through trading platforms may effectively be making unsecured loans to those companies.<sup>13</sup> Additionally, last November, the President’s Working Group on Financial Markets released a report highlighting the financial risks of stablecoins and expressing concerns about custody issues in relation to them.<sup>14</sup> We note that potential uncertainties relating to crypto-asset custody may be further complicated when considering the impact of state laws, including money transmitter laws, which may apply in such cases. U.S. crypto-asset exchanges are generally formed as state trust companies, and relevant state trust company laws may require the exchanges to hold customer assets as fiduciaries.<sup>15</sup>

One crypto-asset exchange responded to concerns regarding crypto-asset custody by claiming that the crypto-assets that it protects are safe, as the exchange is currently not at risk of bankruptcy.<sup>16</sup> Further, the exchange noted its intention to update user terms to offer some protections in the case of a “black swan event” (*i.e.*, an unpredictable event that exceeds normal expectations and has potentially severe consequences) and take additional steps to further protect customer crypto-assets in the event of bankruptcy.<sup>17</sup>

In conclusion, there remains potential uncertainty regarding the treatment of crypto-assets in bankruptcy due to limited legal precedent. As noted earlier, a determination regarding whether a customer’s assets are property of a debtor’s estate in a bankruptcy proceeding is a fact-specific analysis that is determined by the arrangement governing the crypto-assets. Accordingly, this is another important factor in determining what account structure a customer will obtain from a crypto-exchange, which could mitigate this uncertainty.

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<sup>13</sup> *Id.*

<sup>14</sup> Satish Kini et al., “President’s Working Group on Financial Markets and Federal Banking Regulators Issue Report on Stablecoins,” *Debevoise & Plimpton Fintech Blog* (Nov. 8, 2021), available at <https://www.debevoisefintechblog.com/2021/11/08/presidents-working-group-on-financial-markets-and-federal-banking-regulators-issue-report-on-stablecoins/>.

<sup>15</sup> See also Aseel Rabie & Jonathan Steinberg, “The State of Money Transmission Regulation and Digital Assets in 2022,” *Debevoise & Plimpton FinTech Blog* (Feb. 1, 2022), available at <https://www.debevoisefintechblog.com/2022/02/01/the-state-of-money-transmission-regulation-and-digital-assets-in-2022/>.

<sup>16</sup> Tim Smith, “Coinbase Says No Bankruptcy Risk Amid Black Swan Event,” *Bloomberg* (May 11, 2022), available at <https://www.bloomberg.com/news/articles/2022-05-11/coinbase-ceo-says-no-risk-of-bankruptcy-amid-black-swan-event>.

<sup>17</sup> *Id.*

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