# SEC Reporting Guidance Poses Challenges For Crypto-Assets

By **Gabriel Benincasa and Barbra Parlin** (June 2, 2022)

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Three recent proposals from the U.S. Securities and Exchange Commission impose new and potentially problematic reporting requirements on the crypto and digital asset industry.

The merits of these proposals may be debatable, but it's become apparent to those closely watching the SEC's actions regarding cryptocurrency that Staff Accounting Bulletin 121 is challenging for all reporting companies engaging in digital asset custodial activity.

For financial institutions, digital platforms and their crypto-holding customers, SAB 121 is extremely problematic. One need look no further than the Form 10-Q that Coinbase Global Inc. released on May 10, and the subsequent tweets by CEO Brian Armstrong, to see the challenges posed.

SAB 121 calls for entities to treat crypto-assets they hold or safekeep on behalf of customers as assets and liabilities on the companies' balance sheets, which is markedly different from how banks and custodians currently categorize securities and other off-balance-sheet exposures — by providing a footnote disclosure of the amount held or safeguarded for the customer.

By treating digital assets held in custody for others as assets and liabilities, SAB 121 leaves an important question unanswered: If a crypto platform were to commence a bankruptcy case, would custodially held assets and liabilities become property of the platform's bankruptcy estate?

As discussed below, the answer is likely no. However, the fact that the "property of the estate" question is raised without a clear answer may deter investors, embolden creditors and invite costly litigation.

To determine whether property held by a custodian is considered property of a debtor's estate, courts "first must determine the scope of the debtor's property rights under state law," according to the U.S. Court of Appeals for the First Circuit in In re: Montreal, Maine & Atlantic Railway in 2018.[1]

Fortunately, state law often excludes from property of the estate assets held by a debtor for others. Examples of excluded assets include assets held custodially for a debtor's minor children, assets held by a debtor as bailor or warehouseman, assets held by a debtor as trustee, and assets held by a debtor as agent for another.

The U.S. Supreme Court has established precedent that is consistent with that set by the states. In U.S. v. Whiting Pools Inc., the court began its analysis of property of the estate under Bankruptcy Code Section 541 by noting that "[b]oth the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate."[2]

However, the court further observed that the legislative history of Section 541 "indicates that Congress intended to exclude from the estate property of others in which the debtor

had some minor interest such as a lien or bare legal title."[3]

And the court also stated that "Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition."[4] Whiting Pools therefore clarifies that federal law generally excludes from "property of the estate" property held for others by a debtor.

Although the SEC guidance will not change the insolvency analysis of digital asset ownership during a platform's bankruptcy, requiring such entities to classify crypto-assets as assets and liabilities on their balance sheets might confuse investors, creditors and others during such a bankruptcy.[5]

If an item is listed as an asset on a debtor's balance sheet, a creditor could argue that such asset is property available for distribution to creditors through the bankruptcy process.

The balance sheet distinction has major implications. For customers of affected SEC reporting entities, on-balance-sheet treatment of digital assets could enable creditors of those entities to reach previously remote assets if the entity files for bankruptcy.

In typical bankruptcy proceedings, customers' securities or other off-balance-sheet assets are not affected because they are held in trust for the customer as the property of the customer, not a balance sheet asset of the custodian.

SAB 121 is also extremely problematic for covered companies.

For financial institutions in particular, the movement of a significant asset class exposure from off-balance-sheet to on-balance-sheet creates interactions with regulatory capital and capital weighting rules that do not seem to have been adequately considered in advance.

Not only will financial institutions be unable or unsure of how to comply with SAB 121 until it is harmonized with regulatory capital requirements, but any additional associated capital charges at all could also make digital asset exposures too costly for financial institutions.

As financial institutions are likely the most qualified to understand and manage the operational risks of a digital asset safekeeping business, this is also a serious loss for consumers.

Even though SAB 121 is just a bulletin issued for guidance purposes, in reality it is a form of rulemaking. While these bulletins are characterized as interpretations of generally accepted accounting principles, covered companies almost always adopt SEC accounting guidance. To underscore the point, the SEC can pursue enforcement as a remedy against those who fail to adopt SAB 121.

Coinbase has already taken notice and declared potential impacts in its first-quarter 2022 Form 10-Q, disclosing that because "custodially held crypto assets may be considered property of a bankruptcy estate, in the event of a bankruptcy, the crypto assets we hold in custody on behalf of our customers could be subject to bankruptcy proceedings and such customers could be treated as our general unsecured creditors."

The 10-Q goes on to conclude that, because of this policy, customers might find its platform more risky and less attractive, ultimately affecting Coinbase's overall business.

By treating digital assets different from other off-balance-sheet exposures, like securities,

the SEC may be subjecting customers, including retail customers, to insolvency risks that they previously did not have.[6]

Moreover, the rationale to treat crypto-assets different from other off-balance-sheet assets held by custodians is unclear.

The stated rationale in SAB 121 is that, due to technological, legal and regulatory risks, crypto-assets necessitate on-balance-sheet treatment. Yet, securities records — just like crypto-assets — are maintained on ledgers, albeit that such ledgers are decentralized in the case of crypto-assets.

SEC Chairman Gary Gensler, in his May 17 House Appropriations Committee hearing, stated that "most of the [crypto] tokens are likely to be securities, if a [crypto exchange has] even one on [its] platform [it] should register with the SEC."

Thus, is it good accounting for custodians when safekeeping assets to treat crypto-assets as on-balance-sheet and securities as off-balance-sheet, especially given the potential to weaken investor protection?

One positive development that has arisen from the issuance of SAB 121 is that platforms are reviewing their customer and user agreements and disclosures and making it clear they hold assets for customers, and ownership of such assets do not transfer to the platform. That is a welcome change that could benefit customers.

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[1] Keach v. Wheeling & Lake Erie Ry. (In re Montreal, Me. & Atl. Ry.), 888 F.3d 1, 7 (1st Cir. 2018).

[2] Id. at 204.

[3] Id. at 205 n.8.

[4] Id. at 205 n.10.

[5] This issue was raised at Mark Uyeda's Senate confirmation hearings to be confirmed as an SEC Commissioner. Responding to concerns that the SEC's recently published SAB 121 will require crypto assets as on balance sheet liabilities and thereby "weaken investor protections" in the event of a firm's insolvency, Mr. Uyeda mentioned "there has been a tremendous amount of concern raised [about the bulletin] and pledged as a follow up 'to talk with the staff' and Federal and State Banking regulators as to how this interplays with their regulatory regimes." Senate Banking Committee Hearings May 19, 2022.

[6] This analysis does not apply to registered broker-dealers who maintain secure accounts in accordance with the Customer Protection Rule.