SCALE LLP

CLIENT ALERT

SEC Proposes Crypto Custody Framework and Broad Modernization of the Advisers Act Custody Rule

Summary

On October 6, 2026, the Securities and Exchange Commission (SEC) published a significant proposal titled *Adviser and Regulated Fund Custody Rules; Crypto Custody Rules*. For registered investment advisers, the proposal would overhaul the custody rule, Rule 206(4)-2 under the Investment Advisers Act of 1940 (Advisers Act), which would be redesignated as Rule 223-1. Specifically, it would, for the first time, establish a tailored framework for advisers to custody client crypto assets, and it would also modernize long-standing custody requirements that apply to all registered advisers, including private fund managers and separate account managers, regardless of whether they invest in crypto assets. The proposal also contains parallel Investment Company Act of 1940 rules for registered investment companies and business development companies (together, "regulated funds"). Comments are due December 7, 2026.

For advisers, the proposal has three principal components:

1. **Adviser self-custody.** Advisers could hold client crypto assets themselves when no qualified custodian is available, subject to extensive safeguards.
2. **State trust company custody.** State-chartered trust companies would become an express category of "qualified custodian" for client crypto assets, subject to diligence and ongoing conditions.
3. **Advisers Act custody rule modernization.** The custody rule would be updated in a number of practical respects, including changes to the private fund audit provision, a new exception for discretionary trading authority, a surprise examination exception for standing letters of authorization, and elimination of the PCAOB-registered accountant requirement.

The proposal also includes corresponding recordkeeping amendments under Rule 204-2 under the Advisers Act and new Form ADV disclosure items, including new questions on crypto asset self-custody, State trust company custodians, and tokenized private funds.

Item	Detail
Release	Release Nos. IA-7023; IC-36353; File No. S7-2026-35
Federal Register publication	October 6, 2026
Comment deadline	December 7, 2026
How to comment	SEC internet comment form, or email rule-comments@sec.gov with File No. S7-2026-35 in the subject line; or paper comments to the SEC Secretary
Key new/amended rules	For Rule 206(4)-2 (redesignated as rule 223-1), Rule 204-2, and Forms ADV and ADV-E. The release also proposes Investment Company Act rule changes for regulated funds (including new Rules 17f-8 and 17f-9).

Background

Under current law, Rule 206(4)-2 under the Advisers Act is designed to safeguard client funds and securities from loss, theft, misuse, misappropriation, and the adviser's financial reverses, including insolvency. An adviser has custody if it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them, and qualified custodians are currently limited to banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions. The SEC observes that the custody rules were designed for traditional assets and that advisers have encountered obstacles in applying them to crypto assets.

According to the SEC, the proposal responds to the growth of the crypto asset market and to the July 2025 report of the President's Working Group on Digital Asset Markets (established by Executive Order 14178 in January 2025), which, among other things, recommended that the SEC evaluate whether certain State-chartered trusts should be treated as qualified custodians. The SEC also considered feedback, including roundtable input, submitted to its Crypto Task Force. According to the release, without a workable framework that expands the universe of permitted custodians, advisers would be unable to invest client assets in crypto assets for which no permitted custodian is available, limiting investor choice.

The release also explains why existing custodial options are limited. For example, because State trust companies are currently not an enumerated category of permitted custodian as noted above, advisers and funds must conclude that a State trust company is a "bank" (for example, because a substantial portion of its business consists of receiving deposits or exercising fiduciary powers similar to national banks), a fact-specific analysis that has made many reluctant to use them. Moreover, although SEC staff issued a no-action letter on September 30, 2025 permitting advisers and funds to treat State trust companies as banks for crypto custody in certain circumstances (see Section 2 below), the SEC emphasizes that the letter, like all staff statements, has no legal force or effect. In addition, SEC staff noted that even custodians that support crypto assets cannot support all of them, and there may be few or no permitted custodians for nascent or novel crypto assets.

The proposal defines a crypto asset as any digital representation of value recorded on a cryptographically secured distributed ledger, generally consistent with the definition of "Digital Asset" in the GENIUS Act, and the term would include tokenized securities. Ownership is recorded on a crypto network and access is controlled by a private key, which allows the holder to transfer the asset or exercise associated rights such as staking, yield farming, and governance; private keys can be divided into "shards" to disperse control among multiple parties. Importantly, the proposed Advisers Act amendments would apply only to crypto assets that are client funds or securities.



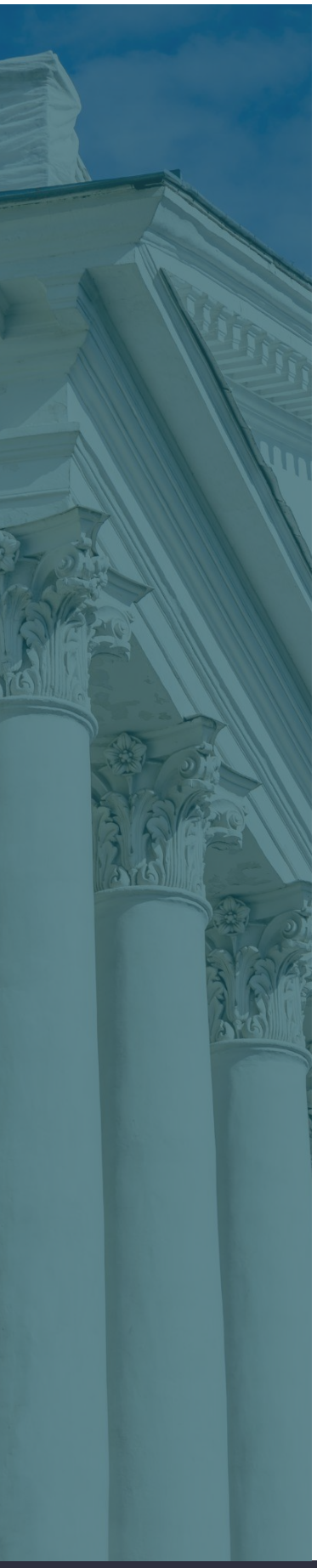
1. Adviser Self-Custody of Crypto Assets (Proposed Rule 223-1(b)(7))

When an adviser has "self-custody"
"Self-custody" would mean possession of any portion of a client crypto asset's key materials (i.e., private keys). An adviser would be covered only if it actually possesses key materials, rather than merely having authority to obtain them. Holding even a non-controlling portion of the key materials (for example, one shard in a multi-party arrangement) would trigger the rule, because loss of any portion could result in permanent loss of the asset. The definition of "custody" would be amended so that self-custody is treated as possession. Self-custody would not include an adviser or related person holding key materials solely in its capacity as a qualified custodian; in that case, the existing related person qualified custodian provisions would apply instead.

Conditions

Self-custody would be an exception from the qualified custodian requirement and related notice and account-statement provisions, but only if the adviser satisfies each of the following conditions:

- **Qualified custodian determination.** Before taking self-custody of each crypto asset, and at least quarterly afterward, the adviser must determine in writing that it has a reasonable basis, after due inquiry, for believing no qualified custodian will maintain the asset. Determinations must be asset-by-asset (no blanket determinations), and cost cannot be the basis for concluding a qualified custodian is unavailable. If a qualified custodian becomes available, the asset must be placed with it as soon as reasonably practicable.
- **Safeguarding expertise and systems.** The adviser must have, and document in writing the basis for, expertise in safeguarding each crypto asset, and must adopt and maintain safeguarding systems that address, at a minimum, private key management, joint authorization of transactions by at least two persons, and segregation of each client's crypto assets in addresses holding only that client's assets.
- **Cybersecurity and annual review.** The adviser must mitigate cybersecurity risks and review its safeguarding systems and cybersecurity controls, in writing, at least annually.
- **Internal control reports.** The adviser must obtain an internal control report from an independent public accountant within six months of taking custody and annually thereafter.
- **Account statements.** At least quarterly, the adviser must send each client an account statement identifying the crypto asset address and network, period-end balances and all transactions, and urging the client to compare it against on-chain information. A human-readable electronic transmission may be used instead, with an accompanying notice.
- **Financial asset election.** The adviser and client must agree in writing to treat each self-custodied crypto asset as a "financial asset" and the adviser as a "securities intermediary" under the applicable state's enacted version of UCC Article 8.



Advisers relying on self-custody would remain subject to the other parts of the custody rule, such as the annual surprise examination (unless an exception, such as the pooled vehicle audit provision, applies). New Form ADV questions would require disclosure of self-custody practices, and the SEC reminds advisers of their fiduciary obligations to disclose the material risks and conflicts associated with self-custody.

Airdrops

The proposal would deem receipt of a distributed (airdropped) crypto asset not to violate the custody rule, provided that the adviser meets specified conditions, generally by bringing the asset into compliance with the self-custody rule or placing it with a qualified custodian. The SEC acknowledges that crypto asset features and custodial practices continue to evolve, and it encourages market participants to contact the SEC about unique or novel arrangements that raise custody questions not addressed by the proposal.

2. State Trust Companies as Qualified Custodians (Proposed Rule 223-1(d)(13)(v))

State trust companies, defined as a legal entity organized under State law that is supervised and examined by a State authority having supervision over banks and permitted to exercise fiduciary powers, would become an additional category of qualified custodian for client crypto assets and related cash. Advisers would no longer need to determine whether such an entity is a "bank," although they could continue to rely on that analysis. Before engaging a State trust company, and annually thereafter, the adviser would need to determine in writing that it has a reasonable basis, after due inquiry, for believing that the trust company:

- ➔ is authorized by the relevant State banking authority to provide crypto asset custody; and
- ➔ maintains and implements written policies and procedures reasonably designed to safeguard crypto assets and related cash from theft, loss, misuse and misappropriation, addressing at a minimum private key management and cybersecurity.

The adviser would also need to receive and review the trust company's most recent annual audited financial statements and internal control report, initially and annually thereafter. All advisory client crypto assets would have to be segregated from the trust company's proprietary assets, and corresponding recordkeeping requirements would apply. Other custody rule requirements, such as the surprise examination, would continue to apply where a State trust company is the qualified custodian, and Form ADV would require advisers to disclose use of a State trust company. The release identifies the September 30, 2025 State Trust Company staff no-action letter among the staff statements that would be superseded to the extent inconsistent with any final rule, and requests comment on whether its rescission should be delayed.

3. Advisers Act Custody Rule Modernization

Using its Dodd-Frank Act Section 411 authority, the SEC would redesignate Rule 206(4)-2 as new Rule 223-1, with conforming changes to Forms ADV and ADV-E. These changes would affect all registered advisers with custody, including private fund and separate account managers. Some of the modernization amendments are consistent with prior interpretive releases, staff FAQs and no-action letters, and the SEC also offers its views on several interpretive topics. Key changes include:

- **Audit provision deadlines.** Annual audited financial statements would need to be distributed within 120 days of fiscal year end for most pooled investment vehicles, 180 days for funds of funds, and 260 days for funds of funds of funds, and could be delivered to an investor's designated independent representative. The SEC states that a failure to meet the deadline due to reasonably unforeseeable circumstances generally would not be a violation if the statements are promptly delivered once those circumstances are resolved.

- **Newly formed funds.** For pooled vehicles formed within the last 90 days of their fiscal year, the adviser could distribute financial statements (which may be unaudited) for the stub period within 90 days, with audited statements covering both the first and second fiscal years delivered after the end of the second year.

- **U.S. GAAP and foreign funds.** All audited financial statements would need to be prepared in accordance with U.S. GAAP, except that non-U.S. pooled vehicles could use other accounting principles with substantially similar information and a reconciliation of material differences delivered to U.S. investors.

- **Discretionary trading and PCAOB.** The rule would specify when authorized discretionary trading authority is excepted from the custody rule, and would eliminate the requirement that accountants performing custody rule audits and examinations be PCAOB-registered and inspected.

- **Standing letters of authorization.** An adviser with custody solely because of a standing letter of authorization would be excepted from the surprise examination requirement, with a corresponding new recordkeeping obligation.

- **BDCs, client notices and discrepancies.** The rule's exception for registered investment companies would expressly include BDCs; client notices on opening a qualified custodian account would need to include the account number; and accountants would send notices of material discrepancies found in surprise examinations electronically to the SEC's Division of Examinations.

- **Inadvertent custody.** The rule would specify circumstances in which an adviser that becomes aware it has inadvertent custody of client funds or securities would not be considered to have custody.

- **SEC views.** The SEC sets out its views on the asset segregation requirement for assets held at qualified custodians and client cash at banks, on escrow accounts used in sales of portfolio companies owned by pooled vehicles, and on when accommodation reporting is permissible. The SEC also expects to revise its 2009 guidance for independent public accountants.

4. Note for Advisers to Registered Funds and BDCs

The release also proposes Investment Company Act rules for regulated funds, including a fund self-custody rule (proposed Rule 17f-9) permitting a fund to hold crypto assets through an adviser that complies with the adviser self-custody rule, subject to board oversight; a State trust company rule (proposed Rule 17f-8); and modernization of the fund custody rules, including express coverage of BDCs, expansion of eligible broker-dealer custodians under Rule 17f-1, rescission of Rule 17f-3 (the free cash accounts rule) and Form N-17f-1, and new Form N-CEN reporting that would require registered investment companies to disclose specific details regarding digital assets and fund structures.

5. Recordkeeping and Disclosure

Advisers relying on self-custody would need to keep, among other things, memoranda supporting qualified custodian and expertise determinations, records of persons with access to key materials, cybersecurity assessments, internal control reports, annual review documentation, client statements and notices, financial asset elections, and records sufficient to reconstruct all client crypto positions and transactions. Advisers using State trust companies and standing letters of authorization would have corresponding recordkeeping obligations. Required records relating to crypto assets could be kept on a crypto network, provided they can be produced promptly (which the SEC would generally interpret as within 24 hours) in a human-readable, reasonably usable format. Form ADV would be amended to implement the self-custody provisions, improve the readability of Item 9, and add Schedule D questions on tokenized private funds, which exempt reporting advisers would also need to answer.

Compliance Timing

Under the proposal, there would be no separate transition period. Advisers could rely on the self-custody and State trust company provisions beginning on the effective date of any final rules, once they can satisfy the applicable conditions and recordkeeping requirements, and could do so before the updated forms become available, provided they file the required information once the updated forms are available and the IARD system can accept it. Compliance with the Advisers Act custody rule modernization amendments (including the discretionary trading, PCAOB, audit provision, standing letter of authorization, inadvertent custody and notice changes) would be required as of that same effective date. The SEC requests comment on whether additional transition time, such as six months or one year, is warranted, including for smaller advisers and for advisers that may inadvertently hold portions of key material.



Key Takeaways and Next Steps

- **Identify any holdings of private keys.** An adviser that holds any portion of a client's private keys, including a key shard in a multi-party computation or multisignature arrangement, would have "self-custody" under the proposal. Advisers should identify these arrangements now and consider whether they could meet the self-custody conditions or would need to move the assets to a qualified custodian.
- **Plan for new compliance processes.** Advisers that expect to self-custody crypto assets would need written, asset-by-asset determinations (initially and quarterly) that no qualified custodian is available, which cannot be based on cost, as well as written client agreements making the UCC Article 8 financial asset election. These would require new documentation, client agreement provisions and internal procedures.
- **Review State trust company diligence.** Advisers that use or are considering a State trust company should compare their current diligence with the proposed requirements, including the initial and annual written determinations and review of the trust company's audited financial statements and internal control report.
- **Review custodian diligence.** Managers using or considering State trust companies should evaluate existing diligence against the proposed initial and annual determinations.
- **Note the private fund audit changes.** Sponsors of funds of funds and funds of funds of funds, newly formed funds and non-U.S. funds may benefit from the proposed audit provision changes and should consider how the new deadlines and delivery options would fit their audit and investor reporting timelines.
- **Monitor the rulemaking.** The proposal is not final and may change. The comment period closes December 7, 2026, and the SEC has requested input on many aspects of the proposal, including the self-custody conditions, airdrop timing, overlap with Regulation S-P and Regulation S-ID, and compliance periods.

Scale LLP is monitoring this rulemaking closely. Please contact your Scale LLP relationship attorney to discuss how the proposal may affect your firm or the funds and accounts you advise.

This client alert is for general informational purposes only and does not constitute legal advice. The proposal is subject to change before any final rule is adopted.



Meet the Author



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Thao has extensive experience counseling clients on the formation and day-to-day operations of private investment funds, both domestic and offshore. He counsels clients regarding the formation of both state and SEC-registered investment advisory firms, as well as the formation of broker-dealers and their registration with FINRA. He also counsels clients on CFTC rules relating to CPO and CTA registration and on the formation of commodity pools.