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Complex Made Simple

Customer Asset Protection

Background

In a legal and financial context, custodian relations often involve the management and safekeeping of assets or property on behalf of another person or entity. Typical custodian relations are relations between a bank and its depositors. Other relations include brokerage firms keeping customer investments, crypto exchanges receiving customer assets, etc.

Custodial relations became a more prominent topic in light of recent scandals involving crypto exchanges and how they safeguard (or should safeguard) customer’s assets.

The first main accounting question involving custodian relations is whether the assets received from customers are considered custodian assets. In other words, should customer assets be reported on custodian balance sheet?

The second question involve segregation of assets provided by customers (e.g., customer deposits) from corporate assets. The question is referred to as comingling of customers assets. Part of the question is whether customer assets are accounted for at the individual customer level or combined with other customer assets.

Segregation of customer assets, as opposed to mixing all assets in one big “pot”, is important as it contributes to security and safety of the assets in question.

Executive summary

Assets or proceeds provided to a custodian should be reported on custodian’s balance sheet if the proceeds are considered assets, from the custodian perspective.

Three essential characteristics of an asset are: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred. (par. 26 of FASB CON 6.)

Generally, custodian assets reported on its balance sheet are subject to claims by custodian creditors.

As an example, a commercial or retail bank will use customer deposits to make loans, which the bank expects to benefit from. The bank can limit the other party’s access to the funds. Therefore, customer cash deposits are considered the bank’s assets and should be recorded on the bank’s balance sheet.

Accounting practices for reporting customer assets vary depending on the industry, including broker-dealer, debt servicing, payment processing, crypto exchanges, etc. Custodians should carefully analyze contractual, legal terms associated with customer proceeds and consult their advisors to establish proper accounting treatment.

Analysis

Typical custodial relations involve a recipient of funds by a custodian and a provider of the funds referred to as an investor or customer, depending on the type of relations. Keeping cash establishes custodial relations whereby the proceeds are kept in custody intended to safeguard the assets.

A custodian should first address the question of how it should report financing proceeds provided by customers. Specifically, the question here is whether funds provided by customers are considered custodian's assets and should be reported on its balance sheet.

Statement of Financial Accounting Concepts (CON) No. 6 *Elements of Financial Statements* defines assets as "…probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." (par. 25 of CON 6).

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> *"…although the ability of an entity to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways."*

A commercial or retail bank, used as an example, will use financing proceeds to make loans, which the bank expects to derive benefits from. The bank can limit the other party's access to the funds. Therefore, customer cash deposits are considered the bank's assets and should be recorded on its balance sheet.

Although GAAP does not provide explicit guidance on how a custodian should account for the assets in custody, a number of accounting practices have emerged in practice.

Brokerage Firms

Brokerage firms regulated by the SEC pool client assets and report them on their balance sheet by debiting assets referred to as assets under custody and crediting liabilities, reflecting an obligation to return the assets to clients. The assets are kept in "street name", i.e., in the name of the brokerage firm and not investor's name. From this perspective, the brokerage, assuming the role of a custodian, acts as an "owner of record" or "nominee owner", different from the "beneficial owner".

When assets are held in "street name", they are often used for a variety of brokerage activities and are subject to legal claims by creditors in the event of the brokerage firm's insolvency.

SEC Rule 15c3-3, including the notion of "good control locations", has certain provisions that require broker-dealers to segregate the customer assets they hold.

Commercial, Retail Banks

U.S. national banks e.g., JP Morgan Chase & Co, U.S. Bank represent a different type of custodian. Investments held by the bank in custody for customers are kept separate from the bank's assets, are not reported on the bank's balance sheet. The assets in question are not subject to the creditor claims. As such, even upon a bank's insolvency, customer assets should be returned to each individual investor. Such assets are referred to as assets under management or assets under custody.

Financial institutions such as a bank or a brokerage firm are generally not entitled to investment gains and do not bear the risk of loss associated with the investments in custody. Instead, the financial institutions are entitled to advisory and investment management fees calculated as a percentage of assets under management (e.g., 1% or 2% a year).

Bank cash deposits or customer deposits are not investments or securities, even if they are held in a custody account. Deposits at a bank are not kept separate and apart from the bank's assets, are reflected on the bank's balance sheet, and are subject to creditor claims.

Crypto Exchanges

According to SEC's recent claim against Binance a cryptocurrency exchange, "…..Binance exercise control of the platforms' customers' assets, permitting them to commingle customer assets or divert customer assets as they please, including to an entity Zhao owned and controlled called Sigma Chain." [1]

Based on currently available information about FTX accounting practices, the crypto exchange did not segregate customer assets either. Instead, customer deposits appear to be comingled with trading positions of Alameda Research, an FTX sister company. According to remarks by FTX Founder Sam Bankman-Fried made in his interview with WSJ:

> "Dollars are fungible with each other. And so it's not like there's this $1 bill over here that you can trace through from start to finish. What you get is more just omnibus, you know, pots of assets of various forms…"[2]

Coinbase is an on-line platform for cryptocurrency transactions. According to disclosures provided by Coinbase in its 10-K:

> "…..we appropriately ledger, properly segregate and maintain separate accounts for our corporate crypto assets and customers' crypto assets."[3]

In its form 10-K, Coinbase provides other disclosures related to customers cash deposits:

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[1] https://www.sec.gov/news/press-release/2023-101

[2] https://www.wsj.com/articles/ftx-founder-sam-bankman-fried-says-he-cant-account-for-billions-sent-to-alameda-11670107659

[3] https://www.sec.gov/ix?doc=/Archives/edgar/data/0001679788/000167978823000031/coin-20221231.htm

> "Customer custodial funds represents restricted cash and cash equivalents maintained in segregated Company bank accounts that are held for the exclusive benefit of customers and deposits in transit from payment processors and financial institutions."

Both customer custodial funds and customer crypto assets are shown separately on the face of Coinbase balance sheet.

It is interesting that audit opinion issued by Deloitte & Touche in relation to Coinbase 2022 year-end financial statements refers to testing of "…the effectiveness of management's control to segregate corporate crypto asset balances from customer crypto asset balances". The reference is made in the critical audit matter section of the audit report.

Payment Processors

PayPal, an online payment processor, reports customer accounts on its balance sheet, separately from non-customer assets. PayPal acts as an agent for certain customer funds. Such funds are not reflected on company's balance sheets. These funds include U.S. dollar funds which are deposited at a third-party financial institutions insured by FDIC.

PayPal facilitates customer transactions in cryptocurrency. Customers' crypto assets are kept with a third-party trust company "in PayPal's name for the benefit of PayPal's customers."[4]. PayPal reports customer crypto as an asset on its balance sheet. In description of its risk factors PayPal indicates that it contractually requires custodians to segregate customer crypto assets and not commingle them with proprietary or other assets. Customer crypto assets are segregated from other assets.

Mastercard Inc and Visa Inc balance sheets show restricted security deposits held for customers and customer collateral balances, respectively. Both assets are shown separately from other assets on the balance sheet. Collateral assets or customer deposits are cash or non-cash client deposits are kept to ensure performance of settlement obligations.

Debt Servicers

A debt servicer services residential and commercial mortgages and other debt instruments. Typical servicing activities include issuing payment statements to borrowers, collection of scheduled principal and interest payments, deposit proceeds, supporting foreclosures, answer borrower's inquiries, issuing forms 1099-INT, etc.

When a debt servicer collects proceeds on behalf of the lender such proceeds are generally not reported on the servicer's balance sheet as its assets.

Generally, terms of servicing agreements require debt servicer to keep lender's cash in specifically designated accounts, separate from those used to account for other cash. Therefore, lender's cash is segregated and not commingled.

Film Studios and co-financing agreements

[4] https://www.sec.gov/ix?doc=/Archives/edgar/data/1633917/000163391723000033/pypl-20221231.htm

In a typical film co-financing arrangement, the investor finances an agreed-on percentage of a film produced by a studio. The studio acts as an investee and a recipient of financing proceeds from the investor.

Generally, film studios receiving financing proceeds report respective proceeds in the escrow account included on its balance sheet. Proceeds are segregated from other studio's assets. However, the above treatment should change if the proceeds kept in the escrow account are not subject to claims of studio creditors, in which case, the assets should not be reported on studio's balance sheet. In such instances, liabilities related to film production financed by third-party investors may not be reported on the studio's balance sheet either.

Accounting practices for reporting customer or investor assets vary depending on the industry and specific terms of custodial relations. Custodians should carefully analyze contractual, legal terms associated with customer or investor proceeds and consult their advisors to establish proper accounting treatment.

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