

What Broker-Dealers Must Know Before Selling Bitcoin ETPs

By **Frank Weigand** and **Justine Woods** (January 15, 2025, 5:20 PM EST)

The approval of bitcoin exchange-traded products a year ago introduced a means by which traditional investors can more easily gain exposure to bitcoin.

The bitcoin ETP is a security under the jurisdiction of the U.S. Securities and Exchange Commission, which enables these investments to be held in brokerage accounts and, for investors comfortable with gaining exposure in an ETP format, eliminates the oft-criticized and somewhat cumbersome process of opening cryptocurrency accounts with digital asset firms or navigating use of a self-custodial digital wallet.

These ETPs have attracted tens of billions of investment dollars to date, and interest is expected to grow further in light of the pro-crypto stance of the incoming Trump administration.[1] This new interest from investors is welcome news for financial advisers, who now have a new asset class for potential addition to client portfolios that goes beyond traditional stocks, bonds and investments traditionally understood as falling into the category of "alternative investments." [2]

However, prior to recommending, or allocating client assets to, a bitcoin ETP, there are numerous regulatory requirements for broker-dealers and their registered representatives to consider.

As the Financial Industry Regulatory Authority recently reminded broker-dealers, "[as] with all business activities, member firms seeking to engage in crypto asset-related activities should proactively identify and address the relevant regulatory and compliance challenges and risks of such activities." [3]

Suitability and Regulation Best Interest

Among the range of regulatory obligations to consider, the FINRA suitability requirements and compliance with the SEC's Regulation Best Interest are critical given the unique nature of this asset class.

FINRA Rule 2111, Suitability, requires broker-dealers to have a reasonable basis upon which to conclude that an investment is specifically suitable for each customer on a case-by-case basis according to an informed assessment of the customer's investment profile.[4]

Based on recent surveys, including one conducted by the Federal Reserve, and released in May,[5]



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millions of American adults own cryptocurrency and, after a measured start in allocating to clients,[6] broker-dealers are starting to become more comfortable with this asset class.

This new comfort is exemplified by Blackrock's December report suggesting that an allocation to bitcoin of 1% to 2% of an investor's portfolio may be appropriate in some cases[7] and firms such as Fidelity publishing research reports with fundamental analyses and investment theses on a range of digital assets.[8]

Even so, the Blackrock report notes that investors allocating to bitcoin should only do so if they "believe it will become more widely adopted in the future" and should be "comfortable bearing the risk of potentially rapid price plunges." [9] The report also cautions that, based on bitcoin's historic volatility, allocations in excess of 2% of an investment portfolio to bitcoin would lead to potentially outsize risk.[10]

In addition, for retail customers, broker-dealers are subject to enhanced obligations under the SEC's Regulation Best Interest, or Reg BI, under the Securities Exchange Act, which "establishes a 'best interest' standard of conduct for broker-dealers and associated persons when they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities." [11]

Notably, in its 2025 Examination Priorities, the SEC identified crypto-assets as an area of focus for upcoming examinations of broker-dealer practices related to Reg BI.[12]

In complying with Reg BI, broker-dealers must fulfill four obligations: (1) a disclosure obligation, (2) a care obligation, (3) a conflict of interest obligation, and (4) a compliance obligation.[13] Of these four obligations, the care obligation is most relevant with respect to the unique nature of crypto ETPs.[14]

Under the care obligation, before recommending or allocating a particular investment to a client, a broker-dealer must first determine that, in light of the potential risks, rewards and costs related to the investment, the recommendation could be in the best interest of at least some retail customers.[15]

If this condition is satisfied, the care obligation also requires a customer-specific determination, i.e., the broker-dealer must also determine that the investment is in the best interest of the specific customer, given that customer's investment profile.[16]

Lastly, the care obligation requires a consideration of reasonably available alternatives to conclude that the investment is in the customer's best interest.[17]

Understanding the Risks, Rewards and Costs

As understanding product risks is such a critical aspect of Reg BI and suitability, broker-dealers will likely need to educate themselves on the intricacies of digital assets and their particular risks.

For example, a unique risk highlighted in the offering materials of one bitcoin ETP cautions that share values can be severely affected by a number of unpredictable factors, such as a "hard fork" created by software updates to a blockchain only accepted by a portion of users, resulting in two separate ledgers.[18] Clearly, this risk factor is not relevant to assets other than cryptocurrency and may relate to a concept with which broker-dealers may not have preexisting familiarity.

Considering the complex and novel nature of crypto ETPs, some have suggested that broker-dealers may find it helpful to hire cryptocurrency experts to provide trainings for their registered personnel in order to satisfy continuing education requirements under FINRA Rule 1250.[19]

These trainings are also critical for members establishing or updating supervisory infrastructure required under FINRA Rule 3110 (Supervision), so such procedures can be tailored to manage crypto-specific risks.

Customer-Specific Analysis

In addition to understanding product risks, broker-dealers must understand a customer's individual risk profile to help determine whether a customer is well-suited for these types of risks.

Investment profiles must be kept up to date and provide sufficient information about an investor's financial situation, objectives, and other characteristics that allow a broker-dealer to have a reasonable basis to conclude that a particular investment or investment strategy is in the best interest of that customer.[20] The assessment of whether there is sufficient information may change based on the investment being recommended.[21]

The SEC has identified crypto-asset securities as a product that may require heightened scrutiny, recommending that broker-dealers obtain customer information that would adequately support a determination that a crypto ETP investment is in the customer's best interest, such as whether the customer has an "identified, investor-specific trading objective that is consistent with the product's description in its prospectus or offering documents." [22]

As a precursor to being able to determine appropriate allocations within customer accounts, broker-dealers must consider how to classify crypto ETPs in terms of asset-class categorization and risk level. For discretionary accounts in particular, investments which are inconsistent with the objectives or restrictions of a customer's account can often lead to claims of unauthorized trading.[23]

To withstand any such claims, broker-dealers should consider whether crypto ETPs fit within existing approvals or whether customer consent specific to these products should be obtained prior to allocating to them.

For example, for longer term customers, written agreements with allocation percentages established before crypto ETPs entered the market may need to be reassessed even where a portion of assets can be allocated to an "alternatives" asset class, in which digital assets could potentially be included.

Given the emerging and sometimes unpredictable nature of the digital asset market, customer consent helps ensure that the customer has had the opportunity to acknowledge and accept the risks involved, and that the broker-dealer's record can support that suitability and Reg BI compliance requirements were met.

Reasonably Available Alternatives

Under Reg BI, in addition to assessing the risks of a product and a customer's investment profile, broker-dealers must evaluate how an ETP offered by a specific issuer compares to potential alternatives. Possible alternatives will include crypto ETPs offered by other issuers as well as other investment types through which an investor could obtain financial exposure to crypto.

However, given the range of alternatives, a broker-dealer

would not need to consider every alternative that may exist (either outside the broker-dealer or on the broker-dealer's platform) or to consider a greater number of alternatives than is necessary in order for the associated person to exercise reasonable diligence, care, and skill in providing a recommendation that complies with the Care Obligation.[24]

While the SEC has acknowledged that some complex products may have "highly particular features that make them unique," it is not necessary for alternatives to be identical. Instead of looking solely at the features of the product, broker-dealers may consider alternatives that similarly meet the customer's objectives and risk profile.[25]

Further to this, broker-dealers may wish to document their evaluation of, and reasoning behind, the reasonably available alternatives considered. Although not strictly required by the SEC,[26] to ensure consistency in how individual brokers meet the foregoing obligation, broker-dealers may consider establishing written policies and procedures for evaluating alternatives.[27]

Conclusion

To be sure, cryptocurrencies are entering the financial mainstream, and the emergence of crypto ETPs has created a means by which all investors can easily access this asset class.

While we expect that rules for broker-dealers participating in this market may change as it develops, at this stage broker-dealer obligations with respect to these products are fundamentally the same as those governing other investment recommendations and are grounded in treating customers appropriately, taking risks into consideration and evaluating each recommendation independently based on its individual facts and circumstances.

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[1] Bitcoin & Ethereum ETFs Stats, Degenz, <https://www.degenz.finance/cryptocurrency/etfs> (last visited Dec. 12, 2024).

[2] Under existing guidance, "these alternative investments do not fall under a common category" and can include "asset-backed securities, distressed debt, and derivative products." Notice to Member 03-71, FINRA (Nov. 11, 2003), <https://www.finra.org/rules-guidance/notices/03-71>.

[3] See FINRA Provides Update on Member Firms' Crypto Asset Activities, FINRA, <https://www.finra.org/rules-guidance/guidance/crypto-assets-update>.

[4] FINRA Rules: 2111. Suitability, FINRA, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111>.

[5] See Economic Well-Being of U.S. Households in 2023, Federal Reserve System Board of Governors 37 (May 2024), <https://www.federalreserve.gov/publications/files/2023-report-economic-well-being-us-households-202405.pdf>.

[6] Tanaya Machel, Advisors 'wary' of bitcoin ETFs are on a slow adoption journey, says BlackRock exec, CNBC (June 16, 2024, 9:19 AM EDT), <https://www.cnbc.com/2024/06/16/advisors-wary-of-bitcoin-etfs-are-on-slow-adoption-journey-says-blackrock-exec.html>.

[7] BlackRock Inv. Inst., Investment Perspectives: Sizing Bitcoin in Portfolios 4 (Dec. 2024), <https://www.blackrock.com/institutions/en-zz/literature/whitepaper/bii-investment-perspectives-december-2024.pdf>.

[8] Fidelity Digital Assets, Coin Report: Ethereum (ETH) (Dec. 6, 2024), <https://fwc.widen.net/s/ftpq2xxx6p/fda-ethereum-coin-report-12-06>; Fidelity Digital Assets, Coin Report: Bitcoin (BTC) (Dec. 6, 2024), <https://fidelitydigitalassets.com/research-and-insights/coin-report-bitcoin-btc>; Fidelity Digital Assets, Coin Report: Litecoin (LTC) (July 17, 2024), <https://fwc.widen.net/s/zqmqcxs55/fda-coin-report---litecoin---12-06>.

[9] Investment Perspectives, *supra* note 7, at 3.

[10] *Id.* at 4.

[11] Regulation Best Interest: The Broker-Dealer Standard of Conduct, 84 Fed. Reg. 33318, 33318 (July 12, 2019), <https://www.federalregister.gov/documents/2019/07/12/2019-12164/regulation-best-interest-the-broker-dealer-standard-of-conduct>.

[12] See SEC, Examination Priorities: Fiscal Year 2025 ("2025 Examination Priorities"), 8 (Oct. 21, 2024), <https://www.sec.gov/files/2025-exam-priorities.pdf>. The examination will include reviews of: "(1) recommendations with regard to products, investment strategies, and account types and whether the broker has a reasonable basis to believe the recommendation is in the best interest of the customer and does not place the broker's interests ahead of the customer's interests; (2) disclosures made to investors regarding conflicts of interest; (3) conflict identification and mitigation and elimination practices; (4) processes for reviewing reasonably available alternatives; and (5) factors considered in light of the investor's investment profile such as investment goals and account characteristics."

[13] 17 C.F.R. § 240.15I-1.

[14] Of course, for the remaining three obligations, it is also imperative that a broker-dealer review its policies and procedures to ensure they are adequately structured to address the nuances of digital assets.

[15] 17 C.F.R. § 240.15I-1(a)(2)(ii)(A).

[16] 17 C.F.R. § 240.15I-1(a)(2)(ii)(B).

[17] 17 C.F.R. § 240.15I-1(a)(2)(ii)(C).

[18] See iShares Bitcoin Trust, Amendment No. 3 to Registration Statement (Form S-1) at 21 (Dec. 18, 2023).

[19] See Sean Coughlin & Christopher, Vaughan, Crypto ETFs: Suitability and Supervision, Fin. Mkts. Assoc.: Mrkt. Sols., June 2022, at 3, <https://assets.contentstack.io/v3/assets/blt5775cc69c999c255/blt4376e830d47558a4/66aba4b12b7be5b28ba78bc8/240624-market-solutions-volume-33-no-2.pdf>.

[20] See SEC Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations at paras. 5-6 ("SEC Standards of Conduct Bulletin") (April 30, 2023), <https://www.sec.gov/about/divisions-offices/division-trading-markets/broker-dealers/staff-bulletin-standards-conduct-broker-dealers-investment-advisers-care-obligations>.

[21] See *id.* at para. 6.

[22] See *id.* at para. 18.

[23] See Ronald A. Holinsky & Charles R. Mills, *Broker-Dealer Regulation* § 11:2 (2d ed. 2020).

[24] Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 34-86031, 84 FR 39178, at 3382 <https://www.sec.gov/files/rules/final/2019/34-86031.pdf>.

[25] See SEC Standards of Conduct Bulletin, *supra* note 23, at para. 14.

[26] See *id.* at para. 16.

[27] See *id.* at para. 10.