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May 8, 2023

Submitted via rule-comments@sec.gov

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090.

RE: Safeguarding Advisory Client Assets Proposed Rule [Release No. IA-6240; File No. S7-04-23; RIN 3235-AM32]

Dear Ms. Countryman:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to provide comments on the Securities and Exchange Commission's ("SEC") proposal to redesignate the existing investment adviser "custody rule" to the new "safeguarding rule" pursuant to authority granted in the Investment Advisers Act of 1940.[2] The proposal would broaden the application of the current custody rule, expand its coverage from "funds or securities" to all client "assets," amend the definition of qualified custodians, and make several other important changes. The community banks and savings associations that comprise our membership are concerned about this proposal because, under the current rule, all are considered to be qualified custodians, but the proposed changes would result in some banks and savings associations becoming ineligible for this designation.

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[1] The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. ICBA is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education, and high-quality products and services. With nearly 50,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 700,000 Americans and are the only physical banking presence in one in three U.S. counties. Holding more than $5.8 trillion in assets, over $4.8 trillion in deposits, and more than $3.8 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org.
[2] 88 Fed. Reg. 14672, available at: https://www.govinfo.gov/content/pkg/FR-2023-03-09/pdf/2023-03681.pdf.

A. Scope of Rule

The current custody rule applies to "funds or securities" of which an investment advisor has custody. The proposed rule would expand the scope of coverage to include all client "assets" where over which an investment advisor has custody. This change would make the rule applicable to a wide variety of assets not covered by the current rule that are neither funds nor securities including physical assets like artwork and commodities, real property, and crypto assets. The proposal does not explicitly define crypto assets, but it describes them as assets that "generally use distributed ledger or blockchain technology … as a method to record ownership and transfer assets."[3]

Under both the current custody rule and the proposed safeguarding rule, investment advisors are required to maintain covered client assets over which they have custody with a qualified custodian, unless the assets are subject to an exemption. We believe that the expansion of the rule to assets that are neither funds nor securities – including crypto assets that are neither funds nor securities – is appropriate and in keeping with the SEC's mandate of investor protection. Requiring these assets to be maintained with qualified custodians is likely to make it more difficult for client assets to be lost or misappropriated by investment advisors.

However, we are concerned that the proposal may create risks to the banking system if large and interconnected banks begin acting as custodians of cryptocurrencies at scale. The failure of FTX, which had a valuation of $32 billion and impacted millions of crypto investors, did not have a substantial impact on the traditional banking system. Because few traditional banks have exposure to the crypto sector, the risk of contagion to the broader financial system that could be posed by the significant volatility of crypto assets currently appears small. However, if banks become more heavily involved in offering custodial services for crypto assets, the potential risk of contagion increases. In fact, the Federal Reserve recently cautioned that financial institutions with revenue or funding models sustained by the crypto asset markets may be exposed to heightened risks due to market volatility and a lack of clear economic use cases.[4] These risks would increase further if a small number of custodians come to dominate this market because it may increase concentration risk.

Additionally, custody of crypto assets presents associated risks to banks due to high levels of fraud and cybersecurity risk related to the sector. According to analysis by Chainalysis, approximately $3.8 billion worth of cryptocurrency was stolen in 2022, the highest level of any year on record.[5] A significant portion of this hacking is done by nation-state supported hackers,

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[3] 88 Fed. Reg. 14676.
[4] Federal Reserve System, "Order Denying Application for Membership, Custodia Bank," FRB Order No. 2023-02 (Jan. 27, 2023), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/orders20230324a1.pdf;
[5] Anna Baydakova, *CoinDesk*, "Crypto Theft Rose in 2022 as Scams, Ransomware Bounty Fell: Chainalysis" (Feb. 16, 2023), available at: https://www.coindesk.com/markets/2023/02/17/crypto-theft-rose-in-2022-as-scams-ransomware-bounty-fell-chainalysis/.

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including North Korea's "Lazarus Group," which stole $1.7 billion in crypto assets in 2022 alone. Last November, an unknown agent also attacked FTX, formerly one of the world's largest centralized exchanges, and stole an estimated $415 million of crypto assets.[6] Although the incident is now under investigation by law enforcement agencies, the identity of the attacker remains unknown, and it is unclear whether any crypto assets will ever be recovered.

Hackers supported by rogue nations are sophisticated, well-resourced, and highly motivated. Acting as custodian for crypto assets may make banks and other financial institutions an even more attractive target for these groups, increasing the risk of a major cybersecurity breach. With these risks in mind, ICBA and its members urge the SEC to prioritize national security and anti-crime measures as it considers crypto assets regulations.

Federal banking regulators have issued warnings about the risks of crypto assets, highlighting the volatility, fraud, legal uncertainty, contagion risk within the crypto sector, and other factors.[7] They have also highlighted the liquidity risks associated with crypto deposits, both from crypto companies and from stablecoin issuers.[8] However, ICBA and its members also note that regulatory environment remains uncertain. Although the Office of the Comptroller of the Currency declared in July 2020 that crypto custodial services are "a permissible form of a traditional banking activity that national banks are authorized to perform," it subsequently clarified that such an activity is only permissible "*provided* the bank can demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner."[9] The FDIC and Federal Reserve have not yet issued detailed guidance on custody services, but all three regulators issued a joint statement that calls attention to various risks associated with crypto assets, including "legal uncertainties related to custody practices."

The joint statement also determined that "holding as principal crypto assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system is highly likely to be inconsistent with safe and sound banking practices."[10] This is a significant statement because at least one entity has proposed holding crypto assets to pay for custodial

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[6] Rohan Goswami, *NBC News*, "FTX says $415 million of crypto was hacked" (Jan. 17, 2023), available at: https://www.nbcnews.com/tech/crypto/ftx-says-415-million-crypto-was-hacked-rcna66211.
[7] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Joint Statement on Crypto-Asset Risks to Banking Organizations" (Jan. 30, 2023), available at: https://www.fdic.gov/news/press-releases/2023/pr23002a.pdf/.
[8] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities" (Feb. 23, 2023), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf.
[9] Office of the Comptroller of the Currency, "Interpretive Letter #1170" (July 22, 2020), available at: https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf; Office of the Comptroller of the Currency, "Interpretive Letter #1179" (Nov. 18, 2021) available at: https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf.
[10] *Supra* note 7.

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clients' trading fees.[11] In response to this entity's request to become a member of the Federal Reserve System, the Federal Reserve Board of Governors once again emphasized that it "has not identified any authority to support the position that national banks are permitted to hold bitcoin, ether, or most other crypto-assets as principal in any amount or for any purpose."[12] Therefore, if a custodial relationship necessitates a bank to hold crypto assets as principal, then regulators will likely not approve of such activity due to enhanced risks to banks and the wider financial system.

ICBA does not take the view that banks cannot manage the risks associated with crypto assets appropriately. However, bankers and regulators must be clear-eyed about the risks associated with crypto assets – which, in many cases, do not represent ownership in any business or a claim on any real assets – and banks must ensure that their exposure to crypto assets does not jeopardize their safety and soundness. Similarly, regulators, including the SEC and the federal banking regulators, should avoid issuing any regulation or guidance that requires or encourages banks to provide custodial services for crypto assets or become more deeply involved in the crypto industry. Banks should be free to conclude whether that involvement with crypto assets is consistent with their standards of risk management.

B1. Definition of Qualified Custodian

As is the case in the current custody rule, the proposed rule would allow "banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions to act as qualified custodians."[13] However, unlike in the current rule, these institutions would be eligible to act as qualified custodians "only if they have 'possession or control' of client assets pursuant to a written agreement between the qualified custodian and the investment adviser."[14] Additionally, in a change from the current rule, in order to serve as qualified custodians, the proposal would require banks and savings associations to "hold client assets in an account that is designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association (i.e., an account in which client assets are easily identifiable and clearly segregated from the bank's assets)."[15]

We do not believe the proposed changes to the requirements for banks and savings associations to serve as qualified custodians are appropriate with respect to client funds. Under the proposed rule, it would be impermissible for an investment advisor to receive funds from a client and to deposit those funds into a Federal Deposit Insurance Corporation ("FDIC")-insured deposit account for safekeeping. This arrangement would be impermissible because a deposit account would not satisfy the requirement for the bank or savings association to "hold client assets in an

[11] *Supra* note 4.
[12] *Id.*
[13] 88 Fed. Reg. 14682.
[14] *Id.*
[15] 88 Fed. Reg. 14683.

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account that is designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association." The proposal states that, while the SEC, "understand[s] that, generally, a bank deposit account creates a debtor-creditor relationship between the bank and depositor" the agency believes that "assets held in accounts of the type proposed by the rule are more likely to be returned to clients upon the insolvency of the qualified custodian because they may pass outside of a bank's insolvency, may be recoverable if wrongly transferred or converted, and are not treated as general assets of the bank."[16]

The SEC's stated view overstates the risk to client funds stored in FDIC-insured deposit accounts in the event of a bank or savings association's insolvency. The FDIC provides deposit insurance for amounts up to $250,000 per depositor, per FDIC-insured bank, per ownership category. The FDIC has never failed to fully reimburse depositors for insured deposits at a failed institution since the agency's creation in 1933.[17] While bank failures may occur and cause losses to uninsured depositors, insured deposits will be protected. Furthermore, the amount of deposits that is insured may be increased by placing deposits at multiple banks or using a deposit placement service.

We believe that the rule, as proposed, would prohibit investment advisers from opening deposit accounts or purchasing certificates of deposit for their clients. This limits investor choice and threatens to remove deposits from the banking system, which could reduce the ability of banks to lend to businesses and consumers. To prevent this outcome, the SEC should not alter the current definition of qualified custodian with respect to FDIC insured banks. The agency should retain the existing definition in 17 CFR 275.206(4)-2(d)(6).

Alternatively, the SEC should specify that custodial service agreements may include a provision that allows a qualified custodian to open and maintain a separate bank account or accounts in FDIC-insured banks in the United States in the name of each client, withdrawable only by the custodian acting in that capacity.

The proposed rule also creates new conditions that foreign financial institutions (FFIs) must satisfy in order to serve as qualified custodians. For example, the proposal would require an investment adviser and the Commission be "able to enforce judgments, including civil monetary penalties, against the FFI" and that FFIs be "[r]equired by law to comply with anti-money laundering and related provisions similar to those of the Bank Secrecy Act."[18] We support the proposed changes for FFIs acting as qualified custodians. They are likely to increase the security

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[16] *Id.*
[17] FDIC, "When a Bank Fails – Facts for Depositors, Creditors, and Borrowers" (July 28, 2014), available at: https://www.fdic.gov/consumers/banking/facts/#definition.
[18] 88 Fed. Reg. 14684.

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of domestic investor's assets custodied by FFIs and to ensure that FFIs acting as qualified custodians are subject to comparable regulations as domestic custodians.

Lastly, to the questions of what type of banks should be considered as "qualified custodians," ICBA and its members assert that only banks insured by the FDIC should be eligible. Special purpose depository institutions, which aim to service the digital assets industry, lack FDIC insurance, and present heightened risks to the financial system. In its order to deny Custodia's application to join the Federal Reserve System, the Board of Governors underscored concerns about Custodia's uninsured status by contending the "absence of deposit insurance coverage at Custodia could increase the firm's risk of runs and contagion."[19] This risk is compounded by several deficiencies, including the fact that examiners found "many of Custodia's underlying policies, procedures, systems, and risk controls for the key proposed crypto-asset-related activities still remain under development."[20] Another concern that bears consideration by the Commission is the absence of guidance from FinCEN and OFAC on the payment of transaction fees to unknown validators. The Federal Reserve specifically identifies this issue as one that must be properly addressed before crypto asset activities can be conducted in a safe and sound manner. Given the fact that fees to validators are necessary to effect successful transfers on blockchains, the Federal Reserve's concerns about banks engaging in this activity without clear guidance from FinCEN and OFAC may impede the ability of banks to support custodial services.

These risks should not be overlooked as the Commission considers its approach to safeguarding crypto assets. ICBA and its members have long warned about the inherent challenges and threats posed by crypto assets, and we support a balanced and cautious approach by regulators to ensure that any bank involvement in crypto activities is consistent with safety and soundness, consumer protection, and other important considerations.

B2. Possession or Control

The proposed rule would require that an investment adviser maintain client assets with a qualified custodian that has possession or control of those assets. "Possession or control" would be defined to mean "holding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership."[21] The proposed requirement for a qualified custodian's involvement being a condition precedent to a change in beneficial ownership is an appropriate safeguard to prevent the unauthorized transfer or misappropriation of an investment advisor's client assets.

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[19] *Supra* note 4.
[20] *Id.*
[21] 88 Fed. Reg. 14687.

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As the agency observes in the proposal, however, there are particular challenges applying "possession or control" requirements to crypto assets. To have "possession or control" of a crypto asset, a custodian would need to be the only entity with access to the private key of the wallet where the crypto asset is stored. If an investment advisor or the beneficial owner of the crypto asset had access to the private key in addition to the custodian, they could effectuate a transfer of the asset without the participation of the custodian. Because of this, unless the custodian has exclusive knowledge of the private key, they do not have "possession or control" of the crypto asset and are not able to act as a true qualified custodian because they cannot provide protection against unauthorized transfers.

Given these challenges, and the lack of detailed guidance from the banking regulators, ICBA and its members ask the SEC to collaborate with the prudential regulators to ensure that any banks that wish to pursue crypto asset custodial services have clear guidelines about acceptable practices to demonstrate "possession or control" and safeguard clients' private keys. In particular, ICBA and its members urge the SEC and the prudential regulators to provide more guidance about the use of hot wallets. Since hot wallets are connected to the internet, oftentimes to facilitate trading activities, they are more susceptible to attacks by unauthorized parties than cold wallets that store private keys offline.

C. Certain Assets Unable to be Maintained with a Qualified Custodian

The proposal states that "the bulk of advisory client assets are able to be maintained by qualified custodians; however, we understand that is not universally the case, particularly for two types of assets: certain physical assets and certain privately offered securities."[22] It further notes that "some qualified custodians may refuse to custody such assets, in part, because the inherent physical characteristics of the items increase the expenses associated with their maintenance and safekeeping."[23] To address these concerns, the SEC is proposing to exempt private securities and certain physical assets from the requirement of being maintained with a qualified custodian, provided that the advisor reasonably determines that no qualified custodian can maintain possession, the adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency, and the advisor is subject to audit by an independent public accountant.

In discussing the proposed rule with community banks, we have heard that fewer banks offer to safeguard physical assets for their customers in safety deposit boxes or bank vaults than in the

[22] 88 Fed. Reg. 14704.
[23] *Id.*

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past, and we believe that trend is likely to continue. Storing a large amount of valuable items on the bank's premises increases the risk of theft, including through violent robbery, and may increase insurance costs to such an extent that banks cannot reasonably offset the expense by charging customers fees for safeguarding their physical assets. Given the trend towards digitization in financial services, banks will likely hold less physical cash on their premises and are unlikely to increase vault space. Therefore, we see the trend of banks being increasingly less likely to offer custodial services for physical assets as unlikely to reverse.

We therefore agree with the SEC's proposal to exempt physical assets and privately offered securities from the requirement of being maintained with a qualified custodian. While some banks may offer to safeguard physical assets, many others will not, or will do so on a limited basis. If investment advisers are required to maintain physical assets with a qualified custodian, it is entirely possible they will not be able to find a qualified custodian that is willing and able to maintain the assets at a reasonable price. This could harm investors and limit their investment options. Some banks will offer custody services for some physical assets, and investment advisers that maintain physical assets with these banks may be relatively more attractive to investors, but this is something best determined by the market, not regulation.

The proposed rule declines to provide a definition of physical assets, arguing instead "that the plain language of the phrase" makes what is and is not a physical asset "self-evident" in most cases.[24] It states that assets like "real estate and physical commodities such as, corn, oil, and lumber are physical assets" while "assets like cash, stocks, bonds, options, futures and funds are not, even if they provide exposure to physical assets."[25] In principal, we agree that the distinction between physical and non-physical assets is often obvious. However, we believe that the agency should provide a definition of physical assets in the rule to prevent future uncertainty.

We believe it would be appropriate for the SEC to define physical assets as "tangible assets that can be seen or touched, including but not limited to physical commodities, real estate, machinery and equipment, and art." The SEC should also clarify in the regulation itself that "physical evidence of ownership of non-physical assets that can be used to transfer beneficial ownership, like stock certificates, private keys, and bearer or registered instruments do not, themselves, qualify as physical assets and would not qualify for the exception from the qualified custodian requirement."[26]

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[24] 88 Fed. Reg. 14706.
[25] *Id.*
[26] 88 Fed. Reg. 14706.

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Conclusion

Once again, ICBA appreciates the opportunity to comment on the SEC's proposed Safeguarding Rule. The proposed rule expands the scope of the existing custody rule in a manner that is consistent with Section 411 of the Dodd-Frank Act. In general, the proposed appears likely to strengthen the current rule and improve the protection of investor assets. Subject to the recommendations made in this letter – specifically with respect to the definition of banks and savings associations able to serve as a qualified custodian – we support the implementation of this proposal.

Please feel free to contact us at Brian.Laverdure@icba.org and Mickey.Marshall@icba.org if you have any questions about the positions stated in this letter.

Sincerely,

/s/

Brian Laverdure, AAP
Vice President, Payments and Technology Policy

/s/

Mickey Marshall
Assistant Vice President and Regulatory Counsel

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