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May 8, 2023

Submitted via e-mail

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
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rule-comments@sec.gov

Re: Comments by the States of Arkansas, Alaska, Idaho, Kentucky, Louisiana, Mississippi, Nebraska, North Dakota, Ohio, Tennessee, Texas, and Utah on the request for comment entitled Safeguarding Advisory Client Assets (File No. S7-04-23)

Dear Secretary Countryman:

The States of Arkansas, Alaska, Idaho, Kentucky, Louisiana, Mississippi, Nebraska, North Dakota, Ohio, Tennessee, Texas, and Utah appreciate the opportunity to submit the following comments in response to the Security and Exchange Commission's proposed "Safeguarding Advisory Client Assets" Rule, 88 Fed. Reg. 14672 (March 9, 2023) ("the Proposed Rule").

Introduction

Long gone are the days when coins had to be traded hand-to-hand. With the advent of banks as third-party intermediaries trusted to maintain a centralized ledger of transactions, direct dealing became far less common. But technological innovation rolls on, and with the advent of the blockchain, peer-to-peer transfers have made a comeback in the form of digital transactions of cryptographic coins, or tokens, recorded on ledgers that are distributed across the Internet. The development of crypto tokens has created a trillion-dollar-plus market with opportunities for innovation and economic growth.

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The Commission lacks the legal authority to adopt the Proposed Rule. Instead, it is up to the States and Congress how best to regulate crypto markets and which agencies should do the regulating. The Commission should decline to adopt the Proposed Rule.

Background

The Investment Advisers Act of 1940, 15 U.S.C. 80b-1 et seq., governs "investment advisers," defined by Congress as advisers in the "securities" business—those who, for compensation, advise others concerning, or who analyze or report on, the value of securities. *Id.* 80b-2(11). In 1962, the Commission's "custody rule," 17 C.F.R. 275.206(4)-2, was adopted to regulate investment advisers "physically holding [a client's] securities," *see* 88 Fed. Reg. at 14673 n.5. The rule has been expanded so that it now reaches all "client funds or securities" that an investment advisor holds "directly or indirectly," including any that an adviser merely has some authority "to obtain possession of." 17 C.F.R. 275.206(4)-2(d)(2). The rule protects funds and securities from loss, misuse, theft, misappropriation, or the adviser's insolvency by requiring investment advisers to maintain them with a "qualified custodian" such as a bank or savings association subject to federal regulation. *Id.* 275.206(4)-2(a), (d)(6).

Specifically, "qualified custodian" means an entity falling into one of four categories: 1) a bank as defined under the Investment Advisers Act, *id.* 275.206(4)-2(d)(6)(i) (citing 15 U.S.C. 80b–2(a)(2)), or a savings association with deposits insured by the Federal Deposit Insurance Corporation, *id.* (citing 12 U.S.C. 1813(b)(1); 12 U.S.C. 1811); 2) a broker-dealer registered under the Securities Exchange Act, *id.* 275.206(4)-2(d)(ii) (citing 7 U.S.C. 6f(a)); 3) a futures commission merchant registered under the Commodity Exchange Act, *id.* 275.206(4)-2(d)(iii) (citing 7 U.S.C. 6f(a)); or 4) a foreign financial institution that segregates clients' assets from its proprietary assets, *id.* 275.206(4)-2(d)(iv).

The Proposed Rule

The Proposed Rule would replace the custody rule covering "client funds and securities," *id.* 275.206(4)-2(d)(2), with a "safeguarding rule" that both expands the scope of the Commission's regulation and imposes weightier burdens on those being regulated. 88 Fed. Reg. 14672. Instead of applying only to "funds or securities" held by an investment adviser, 17 C.F.R. 275.206(4)-2(a), the Proposed Rule would apply across the board to "substantially all types of client assets held in an advisory account." 88 Fed. Reg. at 14677. Thus, as the Proposed Rule itself acknowledges, a wide array of "physical assets, including artwork, real estate, precious metals, or physical commodities (*e.g.*, wheat or lumber), would be within the scope of the proposed rule." *Id.* at 14679. Especially significant, the Proposed Rule would drastically expand the Commission's regulatory reach beyond what Congress intended, bringing within its purview "all crypto assets, even in the instances where such assets are *neither funds nor securities*." *Id.* (emphasis added); *see id.* at 14674 n.13 (quoting Pub. L. 111-203, 124 Stat. 1376 (2010)).

Indeed, while it is undisputed that the Commission lacks authority to regulate the banks, savings associations, and other custodians holding an adviser's client assets, the Proposed Rule seeks "to make sure" that those entities "provide[] certain . . . protections" to the client. *Id.* at

14677. Among a host of new requirements, the Proposed Rule would require the custodians themselves to "deliver account statements to clients," to obtain "an opinion of an independent public accountant regarding the adequacy of [its] controls," and even "to provide promptly . . . to the Commission" records relating to the client. *Id.* at 14677; *see id.* (enumerating others). The Proposed Rule would accomplish this regulation of banks, savings associations, and other custodians by what it acknowledges to be "a substantial departure from current industry practice." *Id.* at 14691. That is, instead of regulating the custodians directly, the Commission would commandeer investment advisors under its jurisdiction to enforce the requirements through their private contracts—contracts the Commission could not itself enforce. *Id.* at 14677 & n.40 (citing proposed rule 223–1(a)(1)).

The Commission also lacks the legal authority to regulate crypto assets that are not securities, and therefore, the Commission should decline to adopt the Proposed Rule. And, in any event, Congress has signaled that it is likely to delegate authority to regulate crypto to another agency.

I. The Commission lacks the legal authority to adopt the Proposed Rule.

In asserting that the Commission has authority to regulate "all crypto assets, even in the instances where such assets are neither funds nor securities," 88 Fed. Reg. at 14679, the Commission is "claiming to discover in a long-extant statute an unheralded power representing a transformative expansion in its regulatory authority." *West Virginia v. EPA*, 142 S. Ct. 2587, 2610 (2022) (cleaned up). The Commission locates this newfound power "in the vague language of an ancillary provision" of the Investment Advisers Act that has never been used for this purpose. *Id.* (cleaned up).

That provision says, simply, "An investment adviser registered under this subchapter shall take such steps to safeguard client assets over which such adviser has custody[.]" 15 U.S.C. 80b-18b. Its context within the Investment Advisers Act argues against the Commission's effort to pull crypto into its regulatory orbit. Indeed, Congress expressly defined "investment advisers" as advisers in the "securities" business. *Id.* 80b-2(11). Thus, it applies to those who, for compensation, advise others concerning, or who analyze or report on, the value of *securities*—not properties or commodities or currencies.

But even if this provision of the Investment Advisers Act provided "a colorable textual basis" for the Commission's assertion of regulatory power (and it doesn't), "common sense as to the manner in which Congress would have been likely to delegate that power" makes "it very unlikely that Congress ha[s] actually done so." *West Virginia*, 142 S. Ct. at 2609 (cleaned up). "Such a vague statutory grant is not close to the sort of clear authorization required by [the Court's] precedents." *Id.* at 2614. Rather, "the Government must—under the major questions doctrine—point to 'clear congressional authorization' to regulate" the crypto industry. *Id.* (quoting *Utility Air Regulatory Group v. EPA*, 573 U.S. 302, 324 (2014)). The Commission has not done that, and it cannot.

The Proposed Rule represents an effort "to substantially restructure the American [crypto] market," *id.* at 2610, which was valued at around $3 trillion globally in November 2021, although that value has since ebbed somewhat. Fact Sheet: White House Releases First-Ever Comprehensive Framework for Responsible Development of Digital Assets, *The White House* (Sept. 16, 2022). Regardless, as of last year, 20 percent of Americans had "invested in, traded, or used cryptocurrency." Thomas Franck, One in Five Adults has Invested in, Traded or Used Cryptocurrency, *NBC News* (March 31, 2022). The Commission's "claim of unheralded regulatory power over [this] significant portion of the American economy" cannot overcome the "presum[ption] that Congress intends to make major policy decisions itself, not leave those decisions to agencies." *West Virginia*, 142 S. Ct. at 2608, 2609 (quotation and citation omitted). Indeed, the Commission "need[s] more, or at least more clearly delineated, statutory authority to regulate" crypto assets. Hester M. Peirce, SEC Commissioner, Outdated: Remarks before Digital Assets at Duke Conference (Jan. 20, 2023). And, to be sure, "Congress might decide to give that authority to someone else." *Id.* Thus, the Commission should decline to adopt the Proposed Rule.

II. Regulation of crypto is for Congress and the States, not the Commission, to decide.

These concerns are compounded by the likelihood that Congress will delegate authority over crypto not to the Commission but to another agency, and by the significant federalism concerns raised by the Proposed Rule.

A. Congress is likely to delegate authority to regulate crypto to another agency.

The Commission asserts that "most crypto assets are likely to be funds or crypto asset securities covered by the current rule." 88 Fed. Reg. at 14676. But that would constitute an unprecedented extension of securities law, and there are strong reasons to believe that courts will disagree. *See* Lewis Rinaudo Cohen, et al., The Ineluctable Modality of Securities Law: Why Fungible Crypto Assets are Not Securities (Nov. 10, 2022, Discussion Draft) (comprehensively evaluating 266 federal appellate and Supreme Court decisions and concluding that there is no basis in law for classifying most fungible crypto assets as securities); *see also* Brief of Amicus Curiae Coinbase, Inc., *SEC v. Wahi*, No. 2:22CV1009, ECF No. 104 (W.D. Wash. Apr. 3, 2023) (explaining that Coinbase-listed crypto assets are not investment contracts).

In any event, Congress has never given the Commission authority to regulate crypto assets, which are subject to potentially conflicting regulations by other governmental bodies. For example, the Treasury Department's Financial Crimes Enforcement Network treats crypto assets as "virtual currencies." FinCEN Guidance FIN-2019-G001 (May 9, 2019). But for the Internal Revenue Service, on the other hand, crypto "is treated as property," not currency. Internal Revenue Bulletin: 2014-16 (April 14, 2014). At the same time, for the Commodities Futures Trading Commission (CFTC), crypto assets "have been determined to be commodities." An Introduction to Virtual Currency, *CFTC*; *see CFTC v. Russell*, No. 1:23CV2691, ECF 1 ¶ 12 (E.D.N.Y. Apr. 11, 2023) ("Certain digital assets, including bitcoin, ether and USDC, are 'commodities' in interstate commerce."); *accord CFTC v. Zhao*, No. 1:23CV1887, ECF 1 ¶ 24 (N.D. Ill. Mar. 27, 2023). Even the Office of the Comptroller of the Currency has made regulatory moves affecting

crypto assets. *See, e.g.*, Interpretive Letter #1179 (Nov. 18, 2021). And that is not to mention that the 50 States exercise independent authority to regulate in this domain—all of which the Proposed Rule fails to consider.

The Commission should wait for Congress to provide direction, which is on the way. At least three bills concerning crypto regulation have been introduced in Congress, and they give oversight of crypto largely to the CFTC. First, Senators John Boozman and Debbie Stabenow introduced a bill that gives the CFTC jurisdiction over activity involving digital commodities. *See* S. 4760, Digital Commodities Consumer Protection Act (117th Congress). Second, Representative Glenn Thompson introduced a bill that gives oversight of digital commodities exchanges to the CFTC. *See* H.R. 7614, Digital Commodity Exchange Act (117th Congress). And, third, Senators Cynthia Lummis and Kirsten Gillibrand have introduced a bill that would give the Commission jurisdiction only over digital assets that give their holders financial interests in a business entity while giving the CFTC jurisdiction over all others. *See* S. 4356, Lummis-Gillibrand Responsible Financial Innovation Act (117th Congress).

Further, just days ago, 29 members of Congress noted that the Commission is trying to regulate the "digital asset ecosystem" using "frameworks that are neither compatible with the underlying technology nor applicable because the [crypto] firms' activities do not involve an offering of securities." Letter to Gary Gensler, U.S. House of Representatives Comm. on Fin. Svcs. (Apr. 18, 2023). The letter instructed the Commission to "take this opportunity to work with Congress" to ensure that innovators and investors have the "regulatory clarity" they need.

As these actions illustrate, Congress could affirmatively declare that the Commission lacks authority to regulate crypto assets—perhaps even choosing to carve out from the Commission's jurisdiction crypto transactions that it might otherwise regulate as securities. Regardless, Congress and the States alone have the right to make major policy decisions concerning how the promise of this growing technology infrastructure can be best realized.

B. The Proposed Rule raises federalism concerns.

The Proposed Rule also raises significant federalism concerns. The Commission casts doubt on the ability of state-chartered trust companies to provide the newly required custodial services. It recognizes the development of "newly launched state-chartered trust companies that focus on providing crypto asset custody services." 88 Fed. Reg. at 14691. But it expresses doubt that those state-chartered banking entities in fact "offer, and are regulated to provide, the types of protections [it] believe[s] a qualified custodian should provide under the rule." *Id.*

In fact, the Commission flatly declares that "the proposed rule would require such crypto assets to be removed" from "state-chartered trust companies, other state-chartered limited purpose banking entities," and other current custodians. *Id.* at 14742; *see also, e.g.*, Wyoming Division of Banking, No-Action Letter on Custody of Digital Assets and Qualified Custodian Status (Oct. 23, 2020) (declaring a state-chartered public-trust company a "qualified custodian" and permitting it to provide custodial services for crypto assets); *but see* Staff Statement on WY Division of

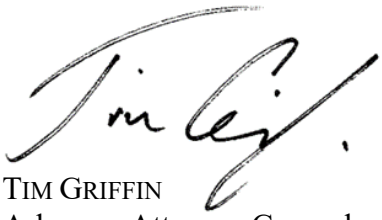
Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status," *U.S. Sec. and Exch. Comm'n* (Nov. 9, 2020) (noting that Wyoming's conclusions are not those of the Commission). The Commission's statements leave many unanswered questions about the Commission's willingness to recognize that, in our federal system, States have a legitimate right to regulate in this domain. The Commission should decline to adopt the Proposed Rule.

III. The Commission has not allowed a meaningful opportunity to fully evaluate the Proposed Rule.

Finally, the Commission has not allowed a meaningful opportunity to fully evaluate the impact of the Proposed Rule on the States. The Proposed Rule was published in the Federal Register on March 9, 2023, with comments due only 60 days later, on May 8, 2023. 88 Fed. Reg. at 14672. We are concerned that the Proposed Rule's complex set of changes, under which the Commission proposes to assert jurisdiction over all custodied crypto assets, will have a profound impact on States' efforts to regulate crypto markets. The Proposed Rule is likely to set in motion irreversible shifts in private involvement with state-chartered banking entities to the detriment of both. The Commission should not only significantly slow its stride to give the States and other stakeholders a reasonable opportunity to evaluate the effects of such consequential changes. It should also reassess the propriety of making such massive changes all at once.

For all the reasons set forth above, the Commission should decline to adopt the Proposed Rule.

Sincerely,



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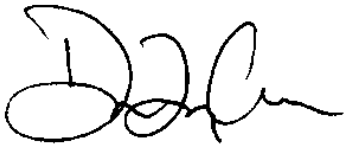

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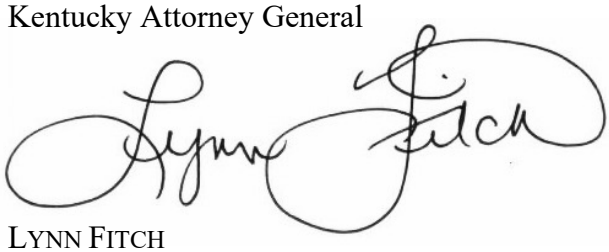

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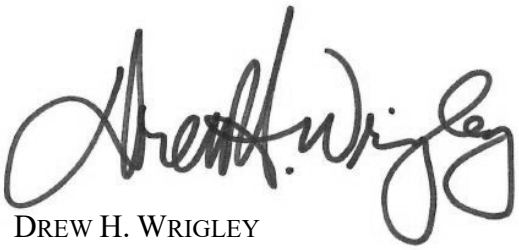

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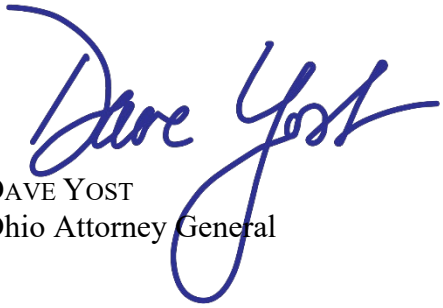

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