May 8, 2023

VIA EMAIL

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

Re: Safeguarding Advisory Client Assets, File No. S7-04-23

Dear Chair Gensler and Commissioners:

Standard Custody & Trust Company, LLC ("SC&TC") appreciates the opportunity to provide comments on the Commission's proposed Rule 223-1 under the Investment Advisers Act of 1940 (the "Advisers Act"), which would reform the requirements for custody of assets managed by registered investment advisers (the "Proposal").[1] Except for the proposed Minimal Custodial Protections, SC&TC supports the Proposal's approach to regulating custody of digital assets[2] managed by investment advisers registered under the Advisers Act ("RIAs"). We are not commenting on the custody of traditional securities and similar investments, as SC&TC does not currently provide custodial services for these assets.

As explained more fully below, we:

- Strongly support the inclusion of state-chartered trust companies in the definition of a "qualified custodian" because of the extensive oversight and supervision provided by their prudential regulators; and

- Oppose requiring RIAs to become party to their clients' custodial agreements and to monitor their clients' custodial relationships because (i) this would involve RIAs and, by extension, the Commission in the supervision and regulation of qualified custodians, which would duplicate and possibly conflict with the efforts of prudential regulators, (ii) this would require RIAs to undertake a role beyond providing investment advice for which they may not be well suited, (iii) this may create

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[1] Release No. IA–6240, Safeguarding Advisory Client Assets, 88 FR 14672 (2023).

[2] The Proposal defines a "digital assets" as "an asset that is issued and/or transferred using distributed ledger or blockchain technology, including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'" 88 FR 14676 n.25.

conflicts of interests between RIAs and their clients and (iv) custodial relationships cannot be reduced to an arbitrary set of impractical assurances.

1. Background on SC&TC and its Custody Services

SC&TC received its trust company charter from the New York Department of Financial Services (the "DFS") in 2021. SC&TC is an institutional-grade custody, escrow and settlement platform for digital assets. SC&TC was founded and designed by leading technologists and innovators from pioneering cryptocurrency and distributed ledger technology companies blended with traditional capital markets expertise. A subsidiary of PolySign, Inc., SC&TC's platform offers novel blockchain technology that provides end-to-end encryption and distributed trust protocols for securing secret keys. SC&TC embodies high standards for regulatory and compliance excellence, empowering financial institutions to leverage their digital asset positions with confidence in best-in-class security protocols.

2. State-Chartered Trust Companies Should Be Qualified Custodians

SC&TC supports the incorporation of the Advisers Act's definition of "bank"[3] into the Proposal's definition of a "qualified custodian." SC&TC is supervised by the DFS and is at least as capable as any bank or registered broker-dealer to safeguard digital assets. As a prudential regulator, the DFS has authority under the New York Banking Law ("NYBL")[4] to monitor, examine, and enforce requirements imposed on limited purpose trust companies. The DFS's Superintendent recently testified to its comprehensive, rigorous, hands-on regulation of trust companies operating in the digital asset space.[5] Generally, "[a]pproval for a . . . [trust] charter requires that companies meet the standards of DFS's comprehensive assessment of controls regarding financial crimes, cybersecurity, capitalization, financial/accounting, character and fitness of controlling parties, operational risk, consumer disclosures, and more."[6]

"In addition, when an entity is approved to be … chartered, DFS creates a detailed supervisory agreement that is tailored to the specific risks presented by the company's business model."[7] "Supervisory agreements are updated on an as-needed basis to take

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3 The definition of a "bank" includes a "trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations." Advisers Act, § 202(a)(2)(C).

4 Chapter 2 of McKinney Consolidated Laws of New York Annotated (West 2021).

5 Understanding Stablecoins' Role in Payments and the Need for Legislation, Hearing before the H, Subcommittee on Digital Assets, Financial Technology, and Inclusion (Apr. 19, 2023) (statement of Adrienne A. Harris Superintendent New York State Department of Financial Services) ("Superintendent Harris Testimony").

6 *Id.* at 3.

7 *Id.*

account of changing business models, market conditions, or other relevant considerations. Licensed companies also must get approval from [DFS] for material changes of business, including for new product offerings …."[8]

Other key requirements and DFS supervisory expectations relevant to the custody of digital assets include:

- The DFS examines trust companies for digital asset specific controls to protect customers, including protection from the risk of hacks, among other safeguards required by the DFS's cybersecurity regulation;[9]

- Trust companies must hold the amount of digital assets delivered by their customers for safekeeping on a one-for-one basis;[10]

- Trust companies must maintain capital based on the specific risks of their business models and other safety and soundness factors;[11]

- Trust companies must provide customers with proper disclosures and transaction receipts, and resolve complaints in a fair and timely manner;[12] and

- Trust companies must have programs to safeguard against illicit transactions.[13]

DFS guidance and supervisory agreements already provide for many of the safeguards identified in the Proposal, particularly segregation of digital assets from the trust company's proprietary assets. We support this fundamental safeguard, and the requirement that a qualified custodian must maintain control of client assets throughout the settlement process. SC&TC already provides these safeguards to its clients.

Section 36 of the NYBL grants the DFS broad authority to conduct examinations as to our financial condition, the policies of our management, whether the requirements of law have been complied with in the administration of our affairs, and such other matters as the Superintendent may prescribe. Examinations are conducted at least annually, and more frequently if the Superintendent deems proper, unless subject to an exception as described in that section.

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8 *Id.*
9 *See* 23 NYCRR Part 500.
10 *See* DFS, Guidance on Custodial Structures for Customer Protection in the Event of Insolvency (Jan. 23, 2023).
11 Superintendent Harris Testimony at 5.
12 *Id.* at 6.
13 *See* 3 NYCRR Part 504.

For trust company examinations, the DFS broadly follows the Federal Reserve System's Commercial Bank Examination Manual.[14] Exams lead to reports with enumerated issues requiring attention, issues requiring immediate attention, an overall rating, and if appropriate, fines. Outstanding issues are subject to follow-up exams or oversight on a risk basis. Under Section 37 of the NYBL, trust companies are required to provide periodic reporting documentation as directed at the discretion of the Superintendent and at minimum twice per year. In practice, the Superintendent typically requires information such as what is contained in Federal Financial Institutions Examination Council call reports.

Under Sections 40, 41, 44, and 44-a of the NYBL, the Superintendent may remove officers and directors or impose fines and penalties, up to and including revocation of a trust company's charter, in the event that a trust company fails to make reports, fails to satisfy exam expectations, or if other enumerated deficiencies are identified. Section 39(2) of the NYBL also gives the DFS authority to order a licensed institution to discontinue any "unsafe and unsound practice" and to impose penalties based on those practices.

Finally, New York trust companies are broadly authorized to exercise fiduciary powers pursuant to Section 100 of the NYBL. The DFS has confirmed that custodian services, including non-discretionary custody, are permissible fiduciary activities under Section 100.[15] These fiduciary powers are clearly "similar to those permitted to national banks" under federal banking law, as interpreted by the Office of the Comptroller of the Currency ("OCC"). In a January 2021 interpretive letter, the OCC's Chief Counsel concluded that a national trust bank "performing in a fiduciary capacity for purposes of state law and operating consistent with the parameters provided for in relevant state laws and regulations may be deemed to be performing in a fiduciary capacity" under federal banking law.[16] Consistent with those principles, the OCC has repeatedly affirmed that state-chartered trust companies who provide digital asset custodial services as a fiduciary under applicable state law—including New York—could also provide those services as a fiduciary after becoming a national bank.[17]

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14 *See* Bd. of Governors of the Fed. Rsrv. Sys., Div. of Supervision & Regul., Commercial Bank Examination Manual (Supp. 53, May 2021), https://www.federalreserve.gov/publications/files/cbem.pdf.

15 *See, e.g.*, New York State Banking Department, Memorandum of January 5, 2010 (determining that a New York banking organization with fiduciary powers would "clearly have the authority to act as custodian or bailee" of customers' artwork pursuant to such fiduciary powers).

16 OCC Chief Counsel's Interpretation on National Trust Banks (Jan. 2021), Interpretive Letter #1176, https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1176.pdf.

17 *See, e.g.,* OCC, Re: Application to Charter Paxos National Trust, New York, New York (Apr. 23, 2021) (applying New York law), https://occ.gov/news-issuances/news-releases/2021/nr-occ-2021-49a.pdf.

3. The Commission Should Not Interject RIAs into Agreements between Qualified Custodians and their Clients

"[T]he proposed rule would require a written agreement between a qualified custodian and the investment adviser," which "would be a substantial departure from current industry practice."[18] SC&TC respectfully submits that there are sound reasons for this "current industry practice," which reflect trade-offs best determined by qualified custodians and their clients rather than by the Commission or RIAs. We therefore oppose the written agreement and reasonable assurances provisions of the Proposal,[19] which the Proposal labels "Minimum Custodial Protections," for the reasons set forth below.

(a) The Proposed Minimum Custodial Protections Exceed the Commission's Authority

Section 223 of the Advisers Act authorizes the Commission to regulate the steps taken by an *RIA*, not a qualified custodian or even an RIA's client, to safeguard client assets over which the *RIA* has custody. The proposed Minimum Custodial Protections, however, would regulate the conduct of qualified custodians. They would, for example, give the Commission the power to request records of a client's assets directly from a qualified custodian without seeking authorization from the client or its RIA. They would also regulate the content of the client's account statements and how a qualified custodian structures client accounts.[20]

Section 223 arguably authorizes the Commission to require RIAs to become parties to their clients' custodial agreements, although we would advise against this, or require RIAs to make reasonable inquiries relating to safekeeping. But a rule that specifies what a qualified custodian must agree to or provide assurances of plainly regulates the custodian's conduct rather than the RIA's. We do not believe the Commission can use Section 223 as a pretext for extending its regulatory oversight to the operations of qualified custodians not already regulated by the Commission, particularly as these entities are already subject to oversight by other supervisory authorities.

(b) There Are Less Intrusive Means to Accomplish Many of these Protections

SC&TC recommends that the Commission focus on what is required to safeguard client assets rather than how these safeguards are implemented. For example, we doubt anyone

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18 88 FR at 14691.

19 Subsections (a)(1)(i) and (ii) of Proposed Rule 223-1.

20 Subsections (a)(1)(i)(A)-(B) and (d)(10)(i) of proposed Rule 223-1. The proposed rule would require the custodian to protect client funds on deposit from claims of credits even though it acknowledges that this may not be possible unless the bank's supervisory authority permits the bank to establish special deposit accounts. 88 FR 14683. This is a clear example of the Proposal intruding into the purview of federal and state supervisory authorities.

objects to providing RIAs with current information regarding their client's positions at a qualified custodian. Custodians routinely provide this information today. But there may be a variety of ways for RIAs to obtain the information, including from sources other than the custodian. A client might provide copies of its statements directly to the RIA or may arrange for a third party to amalgamate information from several custodians and provide consolidated statements to the RIA. Alternatively, the client and the RIA may agree to rely on real-time data available from the custodian's website. The Proposal, however, would mandate that custodians produce at least quarterly account statements to both the client and RIA, regardless of whether they want the information in this format.[21]

Another example is the issue of "inadvertent custody," in which a custodial agreement purportedly gives an RIA sufficient authority to establish custody over the client's assets even when the advisory agreement does not include this authority.[22] It is not clear that this will remain an issue if the definition of "custody" is expanded to include mere investment discretion as proposed.[23] Nevertheless, the issue could be addressed in the advisory agreement rather than the custodial agreement. For example, the client could provide representations as to the level of authority provided in its custodial agreements or the parties could notify the custodian of any limitations on the RIAs authority.

(c) The Commission Should Not Task RIAs with Negotiating their Clients' Custodial Agreement

The proposed Minimum Custodial Requirements are not only a departure from current practice, but they are contrary to the relationship between an RIA and its clients. Clients hire an RIA to advise them "as to the value of securities or as to the advisability of investing in, purchasing, or selling securities."[24] Clients may retain their custodians without consulting their RIAs, and their relationship with a custodian may predate their engagement of the RIA. Under the Proposal, any time a client changes its RIA it will need to renegotiate its custodial agreement to include the new RIA.

The Proposal also fails to consider the possibility that qualified custodians may not have a one-to-one relationship with RIAs. It is not uncommon for a client to engage several RIAs but use a single custodian. The Proposal would require all the RIAs to become parties to the custodial agreement, so their unanimous consent would be required for all subsequent amendments or waivers to the agreement. A new custodian might have to negotiate its

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[21] Furthermore, as explained above, the DFS already regulates the information and disclosures a trust company must make to its custodial customers. There is no reason for the Commission to expend its resources replicating such regulations.

[22] *See* 88 FR 14699.

[23] Subsection (d)(3)(ii) of proposed Rule 223-1.

[24] Advisers Act § 202(a)(11) (definition of an "investment adviser).

custodial agreement not just with its clients, but with all the clients' RIAs and their attorneys, which could increase the time and cost significantly.

On the topic of attorneys, several of the proposed "reasonable assurances" verge on requiring an RIA to provide legal advice. To comply with these proposed assurances, an RIA will need to understand when assets may be subject to the claims of the custodian's creditors, what constitutes "adequate" insurance, and the terms for indemnification. While some of these matters also involve general business advice, none of them relate to investment advice. The Commission has no reason to suppose that every RIA is qualified to advise their clients on these subjects.

We also think it naïve to suppose that RIAs will not raise their own issues when negotiating the custodial agreement. These may include, for example, representations beyond those required by the Proposal, indemnification of the adviser by the custodian, and confidentiality agreements. This may lead to conflicts of interest between the client and its RIA if the RIA refuses to enter into the agreement unless its negotiating points are accepted. Direct negotiations between an RIA and an affiliated qualified custodian may also undermine their operational independence.

(d) The Proposal Underestimates the Complexity of Custodial Relationships

This may be best illustrated by the proposal to require indemnification by the qualified custodian. Contrary to the wording of the proposed rule, negotiation of indemnification involves more than the standard of care. An indemnification provision will also address the scope of losses indemnified, notification periods, tender of defense, and many other matters. Most importantly, the parties will generally agree to a "cap" that is reasonable in relation to the fees receive by the custodian.

What qualifies as "adequate" insurance is equally complicated. It requires the parties to address coverages, coverage limits, deductibles, exclusions, and other considerations. The insurance market for this type of coverage is limited, and mandating coverage may cause premiums to skyrocket. Qualified custodians will need to pass this cost onto their customers, many of whom are not RIA clients. The Commission must weigh this in any cost/benefit analysis of this assurance. The Commission should also consider the possibility that some clients may not want or need this assurance because, for example, they already have first-party insurance to protect against theft or other losses.

Even defining "reasonable care" may be difficult, particularly when dealing with innovative investments such as digital assets. A client may want to use digital assets with a new smart contract, which may involve inherent risks that the client understands and is willing to accept. There would be no "commercial standards" applicable to this circumstance, however; the parties will need to agree on the custodian's specific responsibilities rather than a boilerplate undertaking to use "reasonable care."

Importantly, all of these provisions may impact the safety and soundness of the qualified custodian. This is why business plans submitted by custodians to supervisory authorities typically address insurance and operational controls for safeguarding client assets, which may be incorporated into the supervisory agreement. A supervisory authority has a more comprehensive view of a qualified custodian's business and is therefore better able to tailor "custodial protections" to the specific risks posed by the qualified custodian's business model, and thus will provide better protection than boilerplate assurances to comply with undefined commercial standards.

4. CONCLUSIONS

SC&TC believes that it is important for the Commission to address the safekeeping of digital assets managed by RIAs. In particular, we support the Proposal to require these assets to be maintained under the possession and control of qualified custodians that are regulated by federal and state authorities. We encourage the Commission to respect the role played by other regulatory authorities in supervising their qualified custodians, particularly as these authorities are most familiar with the risks and operations of their supervised entities. We therefore oppose requiring RIAs to become involved in managing their clients' custodial relationships, as we do not expect this to further the interest of clients, RIAs or custodians.

Respectfully yours,

DocuSigned by:
Jack McDonald (personal)
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Jack McDonald
Chief Executive Officer