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Toronto, May 9, 2023

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

Submission to Release Nos. IA-6240; File No. S7-04-23

Dear Ms. Countryman,

I appreciate the opportunity to share my thoughts on the proposed "Safeguarding Advisory Client Assets" amendment to the SEC's Rule 206(4) under the Investment Advisers Act of 1940 ("Advisers Act").

I am a Professor of Finance at the University of Toronto in Canada, with affiliations in the Department of Management at UTM and the Rotman School of Management. I currently hold the Canadian Securities Institute's Research Institute's limited-term chair. My areas of expertise include economic theory, financial market microstructure, and blockchain & decentralized finance, and I have served two terms on the Ontario Securities Commission's Market Structure Advisory Committee.

Undoubtedly, the security of an investor's assets is of paramount importance. I fully support the SEC's efforts to bolster custody requirements for crypto exchanges and related "centralized" (i.e., custody-taking) platforms, following the Ontario Securities Commission's recent practice, in order to effectively segregate client assets and ensure their registration in the client's name.

However, I am concerned that the proposed requirements for Registered Investment Advisers (RIAs) may be overly stringent, potentially harming clients in various ways. I also urge the SEC to adopt a principles-based approach, taking into account the likelihood that advancements in technology and processes may soon enable the achievement of asset segregation and secure storage goals through alternative means.

Specifically:

1. The requirements for Registered Investment Advisors (RIAs) are overly stringent, potentially harming clients seeking investments in crypto-assets.

Recent regulatory advancements in the European Union, such as the passage of MiCA, developments in the United Kingdom, and product innovations by BNY Mellon in the US, suggest that investors may soon have access to tokenized versions of existing securities on public blockchains. This development offers investors the opportunity to fully leverage innovative tools created in the decentralized finance (DeFi) space over the past few years. Systems like automated market makers (AMMs) hold great promise for significantly reducing transaction costs for investors and enabling passive asset holders to deploy their assets, earning incremental income. In forthcoming work with

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Professor Katya Malinova from McMaster University in Canada, we estimate that widespread AMM adoption could save investors billions annually by reducing transaction costs by orders of magnitude. Lower trading costs can increase volume and help firms, particularly less liquid ones, attract investors and capital, ultimately fostering growth and prosperity.

A narrowly defined custody rule requiring the use of specialized custody entities may render it impossible or impractical for RIAs to deploy their clients' tokenized assets in DeFi applications. This restriction could prevent clients from accessing additional income sources, optimizing capital utilization, and trading at significantly reduced costs. Investors would also lose the option to direct their RIAs towards yield aggregation protocols or other non-custodial DeFi services.

DIY clients who still wish to utilize these services independently, could face increased risks and costs and would develop unfavorable risk profiles for their investment portfolio. Arguably, a knowledgeable RIA is better equipped to research and identify suitable applications and strategies for their clients. Furthermore, RIAs may lose the ability to offer a comprehensive suite of services, negatively impacting their business. None of these outcomes align with Congress' intentions.

An alternative might involve allowing centralized custodians to deploy an RIA's client assets based on the RIA's instructions. However, I am not a legal expert, and it seems this approach could conflict with custodians' mandates. DeFi protocols often feature numerous auto-executing functions beyond a custodian's control, potentially violating existing custody obligations. If permitted, such a rule could also affect audit requirements, as client assets may be replaced with receipt tokens, requiring auditors to accept these as proof of ownership and location.

In conclusion, while well-intended, the requirement for exclusive use of a registered custodian represents an outdated solution that clashes with the opportunities presented by modern technologies. I propose developing and allowing procedures through which an RIA can safely and auditably deploy client assets in DeFi protocols.

2. A Principles-Based Approach to Asset Custody

Every asset owner who deposits assets with a "black box" entity, such as a bank, broker, or crypto exchange, faces the challenge of not knowing whether the entity is solvent enough to fulfill any asset withdrawal request. Asset custodianship, which necessitates holding investors' assets in the client's name at a third party, is a direct and extreme solution. However, involving additional parties is inherently expensive, and integrating third-party technology can be costly. While third parties need to be audited, such audits only provide a snapshot in time, and one must rely on the assumption that processes are consistently followed between audits.

An alternative approach could involve making the "black box" entity fully transparent regarding its holdings, specifically its clients' assets and liabilities so that solvency (assets=liabilities) is auditable and visible in real time. While such transparency is unattainable for traditional financial institutions, it may be possible in the world of crypto-assets. Vitalik Buterin proposed such an approach in the aftermath of the FTX collapse in 2022. If executed well, this method could potentially provide investors with the same level of security while reducing costly audits and third-party integration. Achieving lower costs with the same or better security levels would be a highly desirable outcome. However, the feasibility and cost-effectiveness of this approach remain uncertain.

It is crucial for the SEC, when amending Rule 206(4), to acknowledge that alternative technological approaches can be compliant. This consideration helps prevent the creation of an inherently adversarial environment between innovators and regulators. In my opinion, it is important that the

new rule remains flexible and forward-looking, allowing and accepting approaches that achieve the custody rule's objectives without being overly prescriptive in terms of technology.

Respectfully submitted,

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