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Submitted Electronically

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Proposed Rulemaking on Safeguarding Advisory Client Assets
File Number S7-04-23 (February 15, 2023)

Dear Secretary Countryman:

I am a member of the asset management and investment funds practice group at K&L Gates LLP[1] and welcome the opportunity to provide the Securities and Exchange Commission (the "**Commission**") with comments on the Commission's proposal to amend and redesignate Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), to expand the requirements of the Custody Rule (the "**Proposal**").[2] We support the Commission's efforts to modernize the Custody Rule to address recent innovations in technology, advisory services, and custodial practices to further the goal of protecting investors from loss, misuse, theft, or misappropriation. We also appreciate the Commission's careful review of comments prior to finalizing any rule, particularly where the rule may impose onerous burdens on market participants without necessarily furthering the stated policy of the proposed reforms.

As discussed in detail below, we urge the Commission to clarify various aspects of the Proposal as it relates to qualified custodians and digital assets,[3] and to reconsider some of the proposed changes that may create unwarranted burdens for industry participants:

[1] The comments included in this letter reflect the views of a client of K&L Gates that operates a qualified custodian business, and only that client. The views expressed in this letter do not necessarily reflect the views of our other clients, members of our asset management and investment funds practice, other colleagues at K&L Gates LLP, or the firm itself.
[2] Safeguarding Advisory Client Assets, File Number S7-04-23 (Feb. 15, 2023) (the "Proposing Release").
[3] Digital assets, crypto assets, cryptocurrencies, and digital tokens are used interchangeably in this letter.

First, we seek clarification on the basis for the Commission's assertions in the Proposal that crypto assets are likely to be funds or crypto asset securities and that such assets should be subject to the proposed requirements.

Second, we seek clarification on what type of account qualifies as "an account designed to protect assets from creditors of the bank or savings association," as such phrase is used in the definition of qualified custodian under the Proposal.

Third, we explain why the requirements of the Proposal are overly burdensome for, and impose significant additional costs on, advisers and qualified custodians.

If the Proposal is adopted as currently drafted, it will ultimately lead to fewer advisers and qualified custodians able to provide services in relation to digital assets thereby depriving investors of access to this asset class, including access to assets that do not fall within the Commission's jurisdiction. The Commission should recognize the adverse implications of expanding its jurisdiction into non-securities and the conduct of private parties transacting in non-securities, and revise the Proposal accordingly.

1. **We Request Clarification on the Basis for the Commission's Statements Declaring that Crypto Assets are Likely to be Funds or Crypto Asset Securities**

The Proposal would expand the scope of the existing Custody Rule beyond "client funds and securities" to include any "funds, securities, or other positions held in the client's account." The "other positions" language would capture essentially everything that may be in an advisory client's portfolio, including digital assets (bitcoin and other cryptocurrencies, digital tokens, etc.), and other positions that would customarily be held outside the traditional custody framework, because such assets are not securities themselves nor fiat currency held by an adviser for the purpose of acquisition of securities. Such an expansion would require such positions to be held by a qualified custodian. The Commission indicates that by adding section 223 to the Advisers Act in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), Congress authorized the Commission to prescribe rules requiring advisers to take steps to safeguard all client assets, not just funds and securities, over which an adviser has custody. However, we do not believe that Congress intended to expand the scope of the Commission's regulatory power over advisers under the Advisers Act beyond funds and securities, and the text of the Advisers Act and Dodd-Frank support our view. This view is bolstered by the definition of an investment adviser under the Advisers Act, which focuses on the adviser's business activities in relation to *securities*. An investment adviser is defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." In following this logic in a similar vein, we do not believe that through Dodd-Frank Congress granted the Commission newfound authority to pull "other positions" within the ambit of the Advisers Act. Consistent with principles of statutory construction,

if Congress had intended to expand the scope of the Commission's jurisdiction so fundamentally, it would have said so clearly.[4]

While acknowledging that many advisers that manage digital assets take the position that certain digital assets are not currently covered by the Custody Rule because they are not funds or securities, the Commission asserts in the Proposing Release, without any further analysis, that most digital assets are likely to be funds or crypto asset securities. Meanwhile in the footnote accompanying this conclusion, the Commission indicates that to the extent there is a question whether a *particular* crypto asset is an investment contract that is a security, the analysis is governed by the test articulated in the seminal case, SEC v. W.J. Howey, which is a facts and circumstances test. With respect to the assertion that most crypto assets are likely to be securities, the Commission seems to be at odds with itself as it broadly and abstractly asserts that most digital assets are likely funds or crypto asset securities, while disclosing in a footnote to that assertion that any such determination is actually individualized and fact specific. With respect to the assertion that many crypto assets may be considered funds, the Commission provides no explanation or assessment as to which crypto assets are funds rather than securities.

Commissioner Hester Peirce also took issue with the Commission's sweeping statements in her dissent of the Proposal and noted therein her disagreement with the main premise that most crypto assets are securities indicating that these statements have the effect of encouraging advisers to back away from advising clients with respect to crypto assets. We agree with Commissioner Peirce and respectfully ask the Commission to articulate a reasoned basis on which it asserts that digital assets are funds or securities and which crypto assets are securities and which are funds based on the Commission's interpretative framework.[5]

2. We Seek Clarification on the Definition of Qualified Custodian under the Proposal

The Commission indicated that the types of institutions that may serve as qualified custodians are not changing under the Proposal, however, there continues to be ambiguity stemming from the drafting of the definition of qualified custodian. Qualified custodian is defined as "a bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811), provided that the bank or savings association holds the client assets in an account 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."

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[4] *See, e.g.*, Whitman v. American Trucking Association, 531 US 457 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions— it does not, one might say, hide elephants in mouseholes)."

[5] The U.S. Commodity Futures Trading Commission has affirmatively recognized that at least Bitcoin, Ethereum, and Stablecoins are commodities and not securities. The top 10 cyptocurrencies by market cap, which include Bitcoin, Ethereum, Tether and US Dollar Coin, make up approximately 77% of the entire digital asset market and we believe that it is reasonable to assume that qualified custodians would hold assets in proportion to the general market for digital assets.

Specifically, we seek clarity on whether the requirement to have deposits insured by the FDIC also applies to a bank defined in section 202(a)(2) of the Advisers Act in the same manner as it does for savings associations. Furthermore, the requirement in the Proposal that in order to serve as a qualified custodian, a bank or savings association hold client assets in "an account 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" introduces uncertainty as to what type of account would satisfy the requirement.

The Proposal does not adequately account for the possibility that requiring qualified custodians to segregate client assets alone may not be sufficient to establish a special account that would provide protection in the event of insolvency or bank failure. While establishing a special account may be one element in establishing a "trust relationship," additional clear evidence would likely be required to demonstrate a custodian's intent to segregate the assets for the client's benefit. Given that the Commission recognition in the Proposing Release that insolvency laws and procedures vary depending on the bank or savings association's regulatory regime, and the treatment of custodian assets upon a bank's failure can differ in all 50 states, we ask the Commission to clarify what types of accounts would satisfy this condition.

Additionally, while the Proposal did not modify the ability of state-chartered financial institutions to serve as qualified custodians, the Commission raised a number of questions about whether various regulated financial institutions, such as state-chartered trust companies, provide the types of protections that the Commission believes a qualified custodian should provide under the rule. Commissioner Uyeda noted that such statements by the Commission on the quality of regulatory protection and oversight imposed on such institutions inappropriately implies that state regulated banking entities are less trustworthy than federally-chartered ones. Furthermore, the Commission's statements seem to single out and shine doubt on whether state-chartered trust companies in particular provide protections necessary to serve as qualified custodians. We are deeply concerned by the Commission's approach as it could create a chilling effect in practice without actually modifying the Custody Rule. We request that the Commission explicitly confirm the continued viability of a state-chartered financial institution as a "qualified custodian" under the Proposal so that the market has adequate clarity.

3. **We are Concerned that the Custody Rule Expands and Introduces Complexity to the Qualified Custodian's Role and Presents Ambiguity in How Qualified Custodians and Advisers can Comply with the Proposed Requirement to Maintain Possession or Control at All Times**

Under the Proposal, a qualified custodian would be required to maintain *possession or control* of a client's assets. The Commission acknowledged the difficulty in demonstrating exclusive possession or control of digital assets due to their specific characteristics (*e.g.*, being transferable by anyone in possession of a private key). In situations where any person other than the qualified custodian (*e.g.*, the adviser) possesses a private key relating to a digital asset that can transfer ownership of the asset, exclusive possession or control cannot be achieved by the

qualified custodian. Under the Proposal, the Commission also notes that a qualified custodian could also demonstrate that it has "possession or control" where the assets are held in a manner such that an adviser is unable to change beneficial ownership without the custodian's involvement. Where multi-signature technology or similar technology is utilized therefore, a qualified custodian would need to ensure that its involvement is a condition precedent in any change in beneficial ownership in order to demonstrate possession or control. In such cases, qualified custodians would be required to implement key distribution and key signing mechanisms with clients for each wallet used to store digital assets it custodies in order to satisfy their required participation in any change of beneficial ownership, injecting additional complexity and risk in connection with the custodian's duties.

In addition, for advisers not to be deemed to have custody of a digital asset under the Proposal, the adviser will need to ensure that a qualified custodian has the requisite possession or control at *all times*. This also presents unique challenges in the digital asset context because many advisers today trade such assets on digital asset exchanges that settle the trades directly and require investors to pre-fund accounts prior to the execution of a trade. Many of these digital asset exchanges are not considered qualified custodians, and in such cases, when an adviser transfers a client's assets to such an exchange, even for a moment in time to affect trading, the assets would not be deemed to be "maintained" with a qualified custodian, and the adviser would be in violation of the proposed rule. Given the prominence of the practice of pre-funding trades on digital exchanges, complying with this requirement could prove unworkable under the existing paradigm. Significant changes in the way in which advisers currently trade digital assets would be necessitated to comply, and advisers and qualified custodians are left to wonder whether there are any viable options available to trade digital assets that would satisfy the requirements of the rule as presented in the Proposal. In fact, Commissioner Mark Uyeda's statement on the Proposal sums up precisely the question on which we seek clarification: How could an adviser seeking to comply with this rule possibly invest client funds in crypto assets after reading this release? If the exchange itself used a qualified custodian to hold digital assets in the advisers' trading account, would that suffice? If not, why not, and how would such an approach benefit advisers' clients?

4. The Proposal Puts a Heavy Compliance Burden and Imposes Significant Additional Costs on Qualified Custodians and Would Result in Few Advisers and Qualified Custodians Providing Services with Respect to Digital Assets

In a departure from current market practice, the Proposal would require advisers to enter into written agreements with qualified custodians holding their clients "funds, securities and other positions." While this requirement would be a massive undertaking for various market participants in and of itself, qualified custodians would also likely need to amend existing agreements with their clients in order to ensure that relevant terms in those agreements on the one hand and with their clients' advisers on the other, are aligned (*e.g.*, indemnity standards, adviser's agreed upon level of authority, etc.). Furthermore, the practical effect of including discretionary trading within the meaning of "custody" is that advisers participating in wrap programs sponsored by platforms would be required to enter into agreements with each of their client's qualified custodians

(including where the adviser may not know the identity of an end-client's custodian(s)), and under such circumstances, necessitating written agreements covering potentially thousands of the adviser's client accounts. This approach also does not appear to contemplate the situations described in Section 3 above. Accordingly, the Commission's cost-benefit analysis fails to capture the true extent of the costs associated with entering into and modifying these agreements, and may significantly underestimate the overall potential expense to both advisers and qualified custodians. After the initial agreements are executed, qualified custodians would also bear the additional costs of providing periodic written assurances to advisers, who would be required under the Proposal to monitor the custodian's compliance with certain client protections.

In addition to these documentation burdens, the Proposal would mandate that advisers obtain reasonable assurances from the qualified custodian that they: "(1) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss; (2) indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct; (3) not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements; (4) clearly identify and segregate client assets from the custodian's assets and liabilities; and (5) not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client." Moreover, under the Proposal, the adviser would be required to obtain reasonable assurances from the qualified custodians that they have insurance arrangements in place that will adequately protect the client in the event of loss.

Obtaining these assurances from qualified custodians will be extremely difficult for advisers, as qualified custodians will effectively be asked to overwrite negotiated agreements with their custody clients with the language required by the assurances. These requirements would also likely necessitate qualified custodians to amend agreements with clients and sub-custodians as well as to renegotiate insurance policies with insurance providers with corresponding increase in premiums that would be passed on to clients. The insurance requirement may also prove to be particularly costly as all qualified custodians would be seeking coverage, and insurance companies would have little incentive and no mandate to make coverage cost effective. Nor can the Commission compel insurance companies to place policies or to do so in a manner that ensures a healthy market of qualified custodians from which advisers may choose. Moreover, in the digital asset space, the ability of qualified custodians to obtain such insurance would likely prove to be challenging (if not close to impossible) given that the market for custodial insurance for digital assets is not fully developed, and obligating a simple negligence standard could increase prohibitively the cost of such insurance, if it is able to be obtained. In practice, the Commission's Proposal would provide the insurance industry tremendous leverage over advisers and qualified custodians by making coverage decisions that would unduly determine which qualified custodians an adviser can use. Affording such de facto authority to a third party industry could have significant ramifications.

As discussed herein, the onerous and costly obligations proposed to be imposed on advisers with respect to qualified custodians, and their corresponding impact on qualified custodians would have the effect of discouraging custodians from agreeing to provide custody services for certain types of assets, including digital assets. Given that the market for custodial services for digital assets has not yet fully developed and is relatively thin, and that qualified custodians may be unwilling to take possession or control of such assets in light of the additional assurances that advisers must obtain from custodians under the proposed rule, advisers and their clients may be left with very few service provider options if the rule is amended as proposed. The lack of competition coupled with the increased cost of providing custodial services brought about by the Proposal, which would be passed on to investors, would ultimately negatively impact the investors that the Proposal is designed to protect.

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We reiterate our support for the Commission's ultimate goal of seeking to safeguard investor assets. At the same time, we implore the Commission to clarify important aspects of the Proposal noted above, to reconsider the overwhelming costs and burdens presented by the identified additional requirements under the Proposal, and to reconsider the expansion of the Commission's jurisdiction into non-securities and assets other than funds. We appreciated the opportunity to comment on the Proposal.

Please do not hesitate to contact me if you have any questions.

Best regards,

Richard F Kerr
Partner