Multicoin Capital

May 8, 2023

VIA ELECTRONIC SUBMISSION
Ms. Vanessa A. Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Release No. IA-6240; File No. S7-04-23: Safeguarding Advisory Client Assets

Dear Ms. Countryman:

We appreciate the opportunity to provide our views to the Securities and Exchange Commission ("SEC" or the "Commission") on its proposed rulemaking in Release No. IA-6240; File No. S7-04-23: Safeguarding Advisory Client Assets (the "Proposed Rule"), which seeks to amend Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act") with a newly designated Rule 223-1.[1]

Multicoin Capital Management, LLC ("Multicoin") is a registered investment adviser that manages a variety of pooled investment vehicles deploying private capital into promising, technology-focused companies and projects, including those that use blockchain technology. Multicoin was founded in 2017 and registered with the Commission in 2021.

I. *Executive summary.*

The following is an executive summary of our comments, followed by a more detailed explanation of these comments.[2]

- The Commission should retain its focus on disclosure, providing a level playing field for market participants, and allowing for investor choice. The Commission has historically promoted investor protection, capital formation and fair and orderly markets by identifying information asymmetries and ensuring that market participants have the information they need to assess risk. The Proposed Rule departs from that focus.

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[1] Available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[2] Multicoin's comments are provided by General Counsel and Chief Compliance Officer Gregory E. Xethalis and Deputy General Counsel and Compliance Officer Daniel Leonardo. Prior to joining Multicoin in 2021, Mr. Xethalis represented investment management, FinTech and crypto-asset industry clients in private practice for more than sixteen years. He is also Senior Lecturing Fellow at Duke University School of Law, and serves on the boards of the Fordham Law Alumni Association and the Association for Digital Asset Markets. Prior to joining Multicoin in 2022, Mr. Leonardo most recently served for more than six years on the staff in the Private Funds Unit of the Division of Examinations at the Commission. Before that time, Mr. Leonardo provided external consulting services to asset management clients and litigated in private practice for eight years.

- The Commission should extend the comment period to allow for greater industry feedback prior to re-proposal of a new version of the Proposed Rule. While there is no statutory minimum period for comment, a complex and impactful rule proposal requires a reasonable period for industry feedback, which feedback informs and assists the Commission in fulfilling its statutory obligations.
- The Proposed Rule's expansion to assets other than securities and funds should be carefully reconsidered, including by assessing whether the statutory authority exists for such expansion and whether such expansion meets the policy goals of the federal securities laws.
- The contractual requirements and reasonable assurances required under the Proposed Rule are problematic and represent novel overreach into commercial activities and market standards. The Commission is not a merit regulator and does not typically alter commercial terms for service providers, particularly when such service providers (e.g., custodians) are not directly regulated under the federal securities laws.
- The Proposed Rule will impose dramatic new legal, compliance and regulatory costs on registered investment advisers ("Advisers"), custodians, broker-dealers and, ultimately, end investors; these costs are likely to force consolidation in custody markets and more dramatically impact small businesses and those serving underserved markets and communities.
- The Proposed Rule will force market participants, including Advisers, custodians, broker-dealers, trading platforms, and investors, to withdraw from the crypto asset industry, due to increased costs and difficulties directly caused by compliance with the Proposed Rule.
- The Proposed Rule should replace the Minimum Custodial Protections (as defined below) with a disclosure regime for retail customers that expands Form CRS. Amending Form CRS provides important information, while maintaining investor choice and avoiding a material impact on the financial services markets.
- We believe blanket indemnification provisions should not be required for all custodial agreements.
- With respect to privately offered securities, the Proposed Rule should retain the privately offered securities exception of the existing Custody Rule without modifications; however, the Proposed Rule is adopted in the current form, the Commission should lengthen the notification requirements for asset verification and allow for additional validation of discrepancies.
- To the extent it is applied to asset classes other than securities and funds, the Proposed Rule should include both crypto assets and physical assets into the Self-Custodian Exception (as defined below).

II. *The Commission's historical focus on disclosure-based regimes promotes investor choice and the three pillars of the Commission's mission; efforts to adopt or amend rules should follow this path.*

The Commission was formed pursuant to legislation passed in the aftermath of market failures and abuses. The mission of the Commission is to promote investor protection, capital formation, and fair, orderly, and efficient markets; it has historically utilized the power of disclosure to advance these pillars.

By requiring market participants to disclose, as appropriate, comprehensive and accurate information about their operations, financial condition, and risks, the federal securities laws ensure that investors have access to the information they need to make informed decisions. Disclosure promotes transparency, allowing investors to assess the credibility and integrity of companies and enabling them to allocate their capital efficiently. Moreover, disclosure requirements deter fraudulent practices by increasing the visibility of financial activities and promoting accountability. By providing a level playing field for all market participants, disclosure enhances market fairness and reduces information asymmetry. Importantly, disclosure is an investor protection concept that is widely understood, valued, and accepted by market participants.

Disclosure also promotes competition and investor choice, which have historically been advanced by the federal securities laws and the rules promulgated thereunder. We believe that informed investor choice drives American capital markets and that our regulators can facilitate choice by (i) promoting frameworks for investors to receive important information in plain English,[3] (ii) minimizing barriers to entry in order to foster market competition among service providers such as Advisers, broker-dealers, custodians and accountants, and (iii) eschewing merit regulation of asset classes and individual investments.[4] These priorities ensure that investors can enjoy the benefit of their bargain through choice in asset classes, investment terms and contractual provisions.

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[3] The Commission has historically sought to promote Plain English disclosure of material issues relevant to investment decisions. *See, e.g.,* A Plain English Handbook: How to Create Clear SEC Disclosure Documents, March 30, 1999, available at https://www.sec.gov/reports-and-publications/investor-publications/newsextrahandbook. Concise disclosure is challenging when regulation requires the disclosure of vast quantities of information, forcing investors to sort through and determine what information is material to investment or counterparty decisions. Furthermore, highly technical disclosure remains a challenge. For complex products including leveraged funds, scientific and mathematical equations, and code-based functions, disclosure can face a significant tension between accuracy and plain English. *See* Applying a Principles-Based Approach to Disclosing Complex, Uncertain and Evolving Risks, March 15, 2019, available at https://www.sec.gov/news/speech/hinman-applying-principles-based-approach-disclosure-031519. We encourage the Commission to prioritize accurate, technical disclosure over imprecise analogy or Hemingway-esque concision.

[4] The Commission Chair has extolled having "a disclosure-based regime, not a merit-based one." Gary Gensler, "Building Upon a Long Tradition - Remarks before the Ceres Investor Briefing," April 12, 2022, available at https://www.sec.gov/news/speech/gensler-remarks-ceres-investor-briefing-041222. In this speech, Chair Gensler noted that "investors get to decide which risks to take, as long as public companies provide full and fair disclosure and are truthful in those disclosures."

Former Chair Jay Clayton identified the importance of choice in announcing the adoption of Regulation Best Interest and certain other rules and interpretations, noting that they would "bring the legal requirements and mandated disclosures for broker-dealers and investment advisers in line with reasonable investor expectations, while simultaneously preserving retail investors' access to a range of products and services at a reasonable cost."[5] In his nomination hearing, Chair Gensler reaffirmed the importance of investor optionality and noted that regulation of Advisers should focus on preventing self-dealing and conflicts of interest.[6]

While we appreciate that the Proposed Rule seeks to promote investor protection, it does so with sweeping changes to all corners of the financial markets. It is not narrowly tailored and may harm all three pillars of the SEC's mission.[7] As we discuss below, we believe the Proposed Rule (i) has technical issues that make compliance commercially infeasible, (ii) imposes contractual requirements on some parties not generally subject to Commission regulation, (iii) increases regulatory, compliance and contractual costs on market participants, (iv) imposes costs on end investors without providing material new protections for such investors, (v) strips from investors and market participants existing freedoms to contract and explore various asset classes beyond the securities markets the Commission regulates, (vi) results in reduced competition and damages investor choice, and (vii) imposes off-market and unrealistic liability shifting and insurance requirements.[8] We further believe that the Proposed Rule is likely to have a dramatically adverse

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[5] SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals, June 5, 2019, available at https://www.sec.gov/news/press-release/2019-89. Then-Chair Clayton further emphasized the importance of choice in Senate testimony regarding Regulation Best Interest, stating that regulatory "standards should reflect what retail investors would reasonably expect of these financial professionals, while preserving access and choice for investors." Jay Clayton, Testimony before the Financial Services and General Government Subcommittee of the U.S. Senate Committee on Appropriations, May 8, 2019, available at https://www.appropriations.senate.gov/imo/media/doc/05.08.19--SEC%20Clayton%20Testimony.pdf.

[6] In response to supplemental questions presented by Chair Sherrod Brown, Ranking Member Patrick Toomey and other members of the Senate Banking Committee, Chair Gensler stated the following: "I believe that investors should have access to a range of quality options when seeking investment advice and that regulations applied to providers of that advice must protect against self-dealing and mitigate conflicts of interest." Gary Gensler, Supplemental Testimony to the Committee on Banking, Housing, and Urban Affairs, March 2, 2021, available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Resp%20to%20QFRs%203-2-21.pdf ("Gensler Nomination Supplemental Testimony"). *See also* footnote 4, *supra*, and accompanying text.

[7] The Commission has provided limited economic analysis of the impact of the Proposed Rule, and has failed to provide reasonably sufficient time for parties to comment and assess the impact of the Proposed Rule and the other proposed and final rules in the Commission's aggressive rulemaking agenda. We believe it likely that the Proposed Rule's efforts to promote investor protection will backfire by limiting investor choice and driving market participants from core services such as investment advice and custodial services. Limiting investor choice, creating regulatory moats that manifest oligopolies, and increasing the costs of custodial and advisory services is a tragic result and will, in the end, harm investors.

[8] In particular, as we will discuss below, we believe that the Proposed Rule will impose dramatic new costs borne by each of Advisers, Clients and Qualified Custodians (each as defined below), likely resulting in a material reduction in the diversity of service providers and investment opportunities for Clients. This consolidation of service providers will result in greater cost to Clients and the withdrawal from certain asset class markets by a

impact on the ability of investors to access non-standard asset classes including collectibles, hard commodities (e.g., precious metals, industrial metals and agricultural commodities) and crypto assets.

Despite these concerns, we are supportive of the efforts to amend the Custody Rule and to provide further guidance to Advisers on their custody obligation, including in respect of crypto assets; however, the comment period should be meaningfully extended to allow informed public comment, reconsideration and substantial revision of the Proposed Rule, consistent with our recommendations below.

III. *The Commission should immediately extend the comment period to allow for greater industry feedback prior to re-proposal of a new version of the Proposed Rule*.

A. *A comment period of sixty days is insufficient to consider an important, complex rule proposal with a large market impact and that generated a significant number of questions by the Staff*.

A 60-day comment period is not sufficient to adequately consider the Proposed Rule, which is a lengthy and complex document comprising 432 pages and 286 Commission questions. The Administrative Procedures Act ("APA") requires federal agencies to provide interested parties with an opportunity to participate in the rulemaking process by submitting comments and feedback.[9] The Proposed Rule has significant implications for market participants, including broker-dealers, investment companies, Advisers, and their clients ("Clients"), and could have far-reaching consequences for the financial industry as a whole. An extension under these circumstances is not only warranted, but is in line with the justifications that supported the Commission's recent extension of the comment periods for other proposed rules.[10] Moreover, the Proposed Rule will have a material impact on parties (including Clients and commercial custodians) who are not presently regulated by the Commission.[11]

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variety of service providers who find too onerous the potential regulatory, compliance and absolute costs imposed by the Proposed Rule.

[9] 5 U.S.C. § 553(c). Although the APA does not provide a minimum comment period, an exceedingly short comment period, in the context of the underlying issues and complexity of a proposed rule, may support that an agency has not fulfilled its statutory obligations under the APA. *See, e.g.*, N.C. Growers' Ass'n v. UFW, 702 F.3d 755, 770 (4th Cir. 2012). An agency must also respond to significant comments in order to fulfill its statutory obligations. *See* Perez v. Mortg. Bankers Ass'n, 575 U.S. __, 135 S. Ct. 1199, 1203 (2015).

[10] SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS, May 9, 2022, available at https://www.sec.gov/news/press-release/2022-82 (Chair Gensler highlights the extension of comment periods for "three proposed rulemakings that had drawn significant interest from a wide breadth of investors, issuers, market participants, and other stakeholders").

[11] Given the significant scope and technical complexity of the Proposed Rule, the indirect regulation of the commercial and investment activities of parties not typically regulated by the Commission raises material concerns regarding the adequacy of the present comment period. Specifically, such parties may not be as prepared or informed regarding the Commission's rulemaking process, the comment process and the highly

A short comment period is especially problematic for complex and highly technical regulations such as the Proposed Rule, which may require significant time and resources for interested parties to analyze and evaluate, as they may need to consult with internal stakeholders, legal counsel, and other experts to fully understand the Proposed Rule and its implications. We and other industry participants would benefit from and welcome the opportunity to provide more comprehensive feedback to the Commission in subsequent comment letters.

The Proposed Rule poses 286 questions, each of which individually could require extensive research, analysis, and consultation with experts. For several years, through internal deliberations, prior requests for comments,[12] and ongoing examinations of and enforcement actions against industry participants, the Commission has contemplated the structure of the Proposed Rule and the issues it raises. Accordingly, in an extended comment period, we believe that the Commission should provide additional data and greater analysis of these issues, including a summary and response to industry feedback to the Commission's prior requests for comment.

B. The Commission has aggressively proposed and adopted various new rules, regulatory interpretations and enforcement priorities, each of which must be considered in the context of each other; the Commission should be deliberate as it advances its rulemaking agenda.

The contemporaneous introduction of multiple overlapping securities rules, new guidance on the interpretation of existing rules, and enforcement actions that seek to establish precedent on sometimes novel issues could lead to unintended consequences, which may undermine the effectiveness of the rules and harm market participants.[13] Furthermore, the maelstrom of changes

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technical questions for which information is required for the Commission to make informed decisions and fulfill its obligations under the APA. *See id*.

[12] The Commission has not released a summary of industry comments to prior requests for comment which have either expressly requested or otherwise may have generated external or internal comment. *See, e.g.*, Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings, January 8, 2018, available at https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm (raising open issues for investment companies interaction with crypto asset markets, including a focus on custody issues); *see also* Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities, July 8, 2019, available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities (discussing the views of the Staff and the Financial Industry Regulatory Authority on broker-dealer interactions with crypto assets and crypto asset securities, including a discussion of the customer protection rule and acceptable asset class segmentations); *see also* Staff Statement on WY Division of Banking's 'NAL on Custody of Digital Assets and Qualified Custodian Status', available at https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets (discussing and requesting comments on the status of state chartered entities and the implications of crypto assets and qualified custody); *see also* Staff Accounting Bulletin No. 121, April 11, 2022, available at https://www.sec.gov/oca/staff-accounting-bulletin-121 (setting forth certain accounting requirements for public companies operating crypto asset custody businesses).

[13] The Commission has been active in modifying the regulation and obligations of Advisers, the operation of private funds, and the regulation of the crypto asset markets and intermediaries therein. This letter seeks to comment only on the Proposed Rule; however, the new guidance and enforcement actions will undoubtedly impact the application, interpretation and comments available to the Proposed Rule. Members of Congress have introduced both comprehensive and targeted proposed legislation addressing crypto asset markets, including issues relating to custody. *See, e.g.,* Lummis-Gillibrand Responsible Financial Innovation Act, 117th Congress,

to regulation of market participants under the federal securities laws means that the comments to the Proposed Rule will be hampered, as both the Commission and market participants grapple with how each new rule, piece of guidance and enforcement action interact.[14]

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available at https://www.congress.gov/bill/117th-congress/senate-bill/4356/text ("Lummis-Gillibrand") and Digital Commodity Exchange Act of 2022, 117th Congress, available at https://www.congress.gov/bill/117th-congress/house-bill/7614. As the Commission seeks to interpret the authority granted to it under the federal securities laws, it must look to both Congress and the courts for some guidelines in application of that authority. We encourage the Commission to consider the legislative agenda and to avoid seeking to fill the legislative gaps with regulation.

Furthermore, the Commission must consider the regulatory frameworks advanced by other federal agencies, state agencies and foreign governmental authorities. In some instances, these regulatory frameworks have materially longer operating histories, or efforts more geared to incentivize regulatory compliance and good behavior. *See, e.g.,* NYSDFS: Virtual Currency Businesses, available at https://www.dfs.ny.gov/virtual_currency_businesses (the BitLicense regime is preparing to celebrate its ninth anniversary and the New York Department of Financial Services ("NYSDFS") regulates most of the world's largest banks and crypto asset custodians). *See also*, "EU urges others to copy its rules for cryptoassets," April 19, 2023, available at https://www.reuters.com/technology/eu-urges-others-copy-its-rules-cryptoassets-2023-04-19/ (while this comment letter does not opine on the substance of the Markets in Crypto Assets regulation adopted by the European Union, the Commission and other federal agencies should contemplate how these broad new regulations will interact with US regulatory requirements). *See also* Comment to File No. S7-04-23 from the Association for Financial Markets in Europe, the Association of Global Custodians – European Focus Committee, and the European Banking Federation, May 8, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423.htm (broadly discussing the impact of the Proposed Rule on foreign financial institutions and international market and legal frameworks).

[14] A non-exhaustive list of rules taken final by the Commission since January 2022 that have the potential to materially interact with (or impact the market that is the subject matter of) the Proposed Rules include Amendments to Form PF to Require Event Reporting for Large Hedge Fund Advisers and Private Equity Fund Advisers and to Amend Reporting Requirements for Large Private Equity Fund Advisers, File No. S7-01-22, available at https://www.sec.gov/rules/final/2023/ia-6297.pdf (May 3, 2023); Shortening the Securities Transaction Settlement Cycle, File No. S7-05-22, available at https://www.sec.gov/rules/final/2023/34-96930.pdf; Electronic Recordkeeping Requirements for Broker-Dealers, Security-Based Swap Dealers, and Major Security-Based Swap Participants, File No. S7-19-21, available at https://www.sec.gov/rules/final/2022/34-96034.pdf (October 12, 2022); Electronic Submission of Applications for Orders under the Advisers Act and the Investment Company Act, Confidential Treatment Requests for Filings on Form 13F, and Form ADV-NR; and Amendments to Form 13F, File No. S7-15-21, available at https://www.sec.gov/rules/final/2022/34-95148.pdf (Jun. 23, 2022).

A non-exhaustive list of proposed rules promulgated since the start of last year that have the potential to interact with (or impact the market that is the subject matter of) the Proposed Rule include Modernization of Beneficial Ownership Reporting, File No. S7-06-22, available at https://www.sec.gov/rules/proposed/2023/33-11180.pdf (April 28, 2023, reopening of comment period); Amendments to Exchange Act Rule 3b-16 Regarding the Definition of "Exchange", File No. S7-02-22, available at https://www.sec.gov/rules/proposed/2023/34-97309.pdf (April 14, 2023, reopening of comment period); Cybersecurity Risk Management for Investment Advisers, Registered Investment Companies, and Business Development Companies, File No. S7-04-22, available at https://www.sec.gov/rules/proposed/2023/33-11167.pdf (March 15, 2023, reopening of comment period); Regulation Systems Compliance and Integrity, File No. S7-07-23, available at https://www.sec.gov/rules/proposed/2023/34-97143.pdf (March 15, 2023); Cybersecurity Risk Management Rule for Broker-Dealers, Clearing Agencies, Major Security-Based Swap Participants, the Municipal Securities Rulemaking Board, National Securities Associations, National Securities Exchanges, Security-Based Swap Data Repositories, Security-Based Swap Dealers, and Transfer Agents, File No. S7-06-23, available at https://www.sec.gov/rules/proposed/2023/34-97142.pdf (March 15, 2023); Regulation S-P: Privacy of

The Department of Justice recently provided comments to the Commission regarding certain proposed market structure rules, wherein they encouraged the Commission to fully consider the ways in which various proposed rules would interact (the "Antitrust Division Letter").[15] While the Antitrust Division Letter does not address the Proposed Rule, its suggestions are instructive and we believe that an extension of the comment period would be warranted to allow both the Commission staff ("Staff") and commenters to further weigh the dramatically changing environment for Advisers, broker-dealers, investment companies, and parties such as custodians and Clients, who may not already be regulated by the Commission.[16] New overlapping rules can

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Consumer Financial Information and Safeguarding Customer Information, File No. S7-05-23, available at https://www.sec.gov/rules/proposed/2023/34-97141.pdf (March 15, 2023); Regulation Best Execution, File No. S7-32-22, available at https://www.sec.gov/rules/proposed/2022/34-96496.pdf (December 14, 2022); Order Competition Rule, File No. S7-31-22, available at https://www.sec.gov/rules/proposed/2022/34-96495.pdf (December 14, 2022); Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, File No. S7-30-22, available at https://www.sec.gov/rules/proposed/2022/34-96494.pdf (December 14, 2022); Disclosure of Order Execution Information, File No: S7-29-22, available at https://www.sec.gov/rules/proposed/2022/34-96493.pdf (December 14, 2022); Share Repurchase Disclosure Modernization, File No: S7-21-21, available at https://www.sec.gov/rules/proposed/2022/34-96458.pdf (December 7, 2022, reopening of comment period); Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting, File No: S7-26-22, available at https://www.sec.gov/rules/proposed/2022/33-11130.pdf (November 2, 2022, reopening of comment period); Outsourcing by Investment Advisers; File No: S7-25-22, available at https://www.sec.gov/rules/proposed/2022/ia-6176.pdf (October 26, 2022); Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Customer Protection Rule With Respect to U.S. Treasury Securities Fund Advisers; File No: S7-23-22, available at https://www.sec.gov/rules/proposed/2022/34-95763.pdf (September 14, 2022); Clearing Agency Governance and Conflicts of Interest, File No: S7-21-22, available at https://www.sec.gov/rules/proposed/2022/34-95431.pdf (August 8, 2022); Rules Relating to Security-Based Swap Execution and Registration and Regulation of Security-Based Swap Execution Facilities, File No: S7-14-22, available at https://www.sec.gov/rules/proposed/2022/34-94615.pdf (April 6, 2022); Cybersecurity Risk Management, Strategy, Governance, and Incident Disclosure, File No: S7-09-22, available at https://www.sec.gov/rules/proposed/2022/33-11038.pdf (March 9, 2022); Reporting of Securities Loans, File No: S7-18-21, available at https://www.sec.gov/rules/proposed/2022/34-94315.pdf (February 25, 2022, reopening of comment period); and Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, File No: S7-03-22, available at https://www.sec.gov/rules/proposed/2022/ia-5955.pdf (February 9, 2022). In addition, on October 7, 2022, the Commission reopened in mass comments on a variety of rulemaking releases initially proposed from 2010 to 2022, File Nos. S7-32-10, S7-18-21, S7-21-21, S7-22-21, S7-03-22, S7-08-22, S7-09-22, S7-10-22, S7-13-22, S7-16-22, S7-17-22, and S7-18-22, available at https://www.sec.gov/rules/proposed/2022/33-11117.pdf (October 7, 2022).

[15] Comment to File Nos. S7-29-22, S7-30-22; S7-31-22, and S7-32-22 from the Antitrust Division of the U.S. Department of Justice, April 11, 2023, available at https://www.sec.gov/comments/s7-29-22/s72922-20164065-334011.pdf. The Antitrust Division Letter included a suggestion that the Commission consider the impact on market operations that one rule, such as the Market Data Infrastructure Rule, might have before finalizing the remaining market structure proposals.

[16] While the Antitrust Division Letter does not directly implicate the Proposed Rule, the market structure rules for which the Antitrust Division made suggestions will directly and indirectly impact the operations of market participants subject to the Proposed Rule. As a result, the SEC and commenters would equally benefit from a substantial comment period extension to consider the impact of these rules and other finalized or proposed rules, guidance and other precedent.

create unintended consequences that overwhelm the industry, create compliance challenges, and increase regulatory risk.

The Chair notes that it is important to constantly assess the evolution of markets and technology to ensure that rules and regulations adapt appropriately.[17] We agree, and add that change should be narrowly targeted, incorporate industry feedback and be applied at a deliberate pace. With a less sweeping approach, the Staff can take into account potential effects on market participants, investors, and the financial system as a whole.

The rulemaking agenda must also promote all three pillars of the SEC's core values. A rapid tidal wave of rule proposals with insufficient time for market participants to digest, comment and prepare for transition and compliance creates uncertainty that erodes free and fair markets, stifles capital formation and harms investors, even when a rule proposal is well intentioned and seeks to promote one or more of these pillars. As a result, the Commission should extend the comment period and allow the market to digest the substantial changes being implemented.

C. *We join comments from the New York City Bar Association Committee on Private Investment Funds and Committee on Compliance ("NYCBA Letter") and the ABA Securities Association, Alternative Credit Council, Alternative Investment Management Association, American Bankers Association, American Investment Council, Association of Global Custodians, Independent Community Bankers of America, Investment Adviser Association, Investment Company Institute, LSTA, Managed Funds Association, and Securities Industry and Financial Markets Association ("Associations Letter") requesting an extension of the comment period*.

Reference is made to the NYCBA Letter,[18] which highlights the complexity of the Proposed Rule and the significance of its potential impact on the private funds industry, and the Associations Letter,[19] which discusses the complexity of the Proposed Rule and its broad impact on markets

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[17] In his prepared testimony for a confirmation hearing before the Senate Banking Committee, Chair Gensler extolled the importance of harnessing technical innovation and adapting rules to such innovation, stating that "[m]arkets—and technology—are always changing. Our rules have to change along with them." Gary Gensler, Written Testimony, Nomination Hearing Before Senate Committee on Banking, Housing and Urban Affairs, March 2, 2021, available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%203-2-21.pdf.

[18] Comment to File No. S7-04-23 from the New York City Bar Association's Committees on Private Investment Funds and Compliance, April 14, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-20164235-334055.pdf. The NYCBA Letter highlights the complexity of the Proposed Rule and the significance of its potential impact on the private funds industry.

[19] Comment to File No. S7-04-23 from ABA Securities Association, Alternative Credit Council, Alternative Investment Management Association, American Bankers Association, American Investment Council, Association of Global Custodians, Independent Community Bankers of America, Investment Adviser Association, Investment Company Institute, LSTA, Managed Funds Association, and Securities Industry and Financial Markets Association, March 3, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-20164235-334055.pdf. See also Comment to File No. S7-04-23 from LSTA, May 5, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-184639-338442.pdf.

including the commercial custody industry, highlighting the revamp of commercial agreements between Qualified Custodians and Clients and the introduction of new agreements between Qualified Custodians and Advisers. The Associations Letter also cites the potential impact on the businesses of bank industry participants and expresses concern on the ability to weigh and articulate the burdens and costs on market participants, Advisers and Clients.

More broadly speaking, these letters raise red flags regarding the period of time to consider and provide impact on the broad changes set forth in, and material commercial and regulatory impact and burdens of, the Proposed Rule. We join and wish to amplify these comments. We further join the Associations Letter in its reference to the 2022 joint letter from a coalition of trade associations expressing concerns to the Commission Chair regarding the SEC's aggressive rulemaking schedule and limited comment periods provided therefor.[20]

While we request further time to review and research the Proposed Rule, we have provided the following comments. With an extended period of time to provide further comment, we would be pleased to expand upon this feedback and address the Commission's specific questions.

IV. *The Proposed Rule's expansion of the Custody Rule's application to assets other than securities and funds should be carefully reconsidered, including whether the statutory authority exists for such expansion and whether such expansion meets the policy goals of the federal securities laws*.

We note that several commenters have expressed concerns that the Proposed Rule would exceed the statutory authority set forth in the Advisers Act.[21] Specifically, these letters question whether the Advisers Act or the Dodd–Frank Wall Street Reform and Consumer Protection Act authorizes the expansion of the Custody Rule to asset classes beyond Client securities and funds. The Cahill Galaxy Letter further identifies the lack of meaningful Commission guidance for how broker-dealers (a form of Qualified Custodian) may custody crypto assets,[22] and that the Proposed Rule

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[20] Joint Trade Associations' Letter to SEC on the Importance of Appropriate Length of Comment Periods, April 5, 2022, available at https://www.aba.com/advocacy/policy-analysis/ltr-sec-length-of-comment. *See* footnote 14, *supra*, for an example of the aggressive rulemaking agenda that impacts the markets addressed by the Proposed Rule.

[21] *See* Comment to File No. S7-04-23 from the Mercatus Center at George Mason University (Apr. 7, 2023), available at https://www.sec.gov/comments/s7-04-23/s70423-20163827-333933.pdf. *See also* Comment to File No. S7-04-23 from Cahill Gordon & Reindel LLP and Galaxy Digital Holdings, LP, May 8, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-184999-339423.pdf (the "Cahill Galaxy Letter"). *See also* Comment to File No. S7-04-23 from the Blockchain Association (May 9, 2023), available at https://theblockchainassociation.org/wp-content/uploads/2023/05/Blockchain-Association-Comment-Letter-Safeguarding-Rule-2023-05-08.pdf (the "Blockchain Association Letter").

[22] We concur with this concern, noting the lack of Commission response to or summary of industry feedback to prior SEC releases on crypto asset custody. *See* footnote 12, *supra*. We also note that Commissioner Hester Peirce has questioned whether the Proposed Rule exceeds statutory authority by seeking to regulate custodians, over whom the Commission does not ordinarily have jurisdiction. Hester M. Peirce, Statement on Safeguarding Advisory Client Assets Proposal (Feb. 16, 2023) available at https://www.sec.gov/news/statement/peirce-statement-custody-021523 ("Peirce Statement").

seeks to require the use of a limited number of potentially eligible Qualified Custodians. We believe that the Commission should extend the comment period for internal and external feedback and reconsideration of these important questions of statutory authority.

V. *The Proposed Rule will force Advisers and Clients to exit the crypto asset industry if they are forced to comply with regulations strictly based on legacy securities markets, which are often operationally incongruent with crypto asset markets.*

A. *The Proposed Rule's requirements to hold crypto assets with Qualified Custodians should be made more flexible to account for technical issues and changing best practices, including the fact that Qualified Custodians can only custody private key material, rather than the actual crypto assets controlled by such private keys.*

The Commission acknowledges that crypto assets raise unique risks and issues; however, it does not sufficiently address why those differences are important, or the many aspects of distributed ledger networks that justify new regulatory, audit and investor protection tools.[23] Nor does the Proposed Rule explore how the Custody Rule might otherwise be modified to permit and facilitate crypto asset custody and trading in a manner consistent with the Commission's underlying policy objectives.

First, we note that the Proposed Rule does not fully address the where and how of crypto asset custody. A crypto asset is a digital entry or allocation to a public address on a distributed ledger. A custodian of crypto assets ("Crypto Custodian") neither holds the crypto asset, nor is it required to participate in maintenance of the distributed ledger.[24] Instead, a Crypto Custodian maintains the

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[23]More robust discussions of the differences between crypto assets and traditional assets, including securities and hard commodities, and the challenges presented to the crypto asset industry by the Proposed Rule are in the Blockchain Association Letter, the Comment to File No. S7-04-23 from the Crypto Council for Innovation, May 8, 2023, available at https://cryptoforinnovation.org/wp-content/uploads/2023/05/CCI-Comment-Letter-on-Safeguarding-Rule.pdf (the "CCI Letter") and the Comment to File No. S7-04-23 from Andreessen Horowitz, May 5, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-184739-338682.pdf (the "a16z Letter").

[24] Due to the limited comment period and the technical detail relating to public key cryptography, this comment letter will not seek to articulate the appropriate policy-maker's understanding of private keys and crypto assets are held; however, it is important to note that the Proposed Rule similarly lacks such a discussion. Instead, the Proposed Rule oversimplifies crypto asset custody, stating that a Crypto Custodian "would have possession or control of a crypto asset if it generates and maintains private keys for the wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement." Proposed Rule at 67.

The Staff's framework misstates how private keys and crypto assets are held and used, and confuses control of private keys with custody of crypto assets. *See, e.g.*, Letter from Anchorage Digital Bank NA Re: Custody Rule and Digital Assets (Apr. 13, 2021), available at https://www.sec.gov/files/anchorage-041321.pdf ("[T]he nature of cryptographic assets, access to asset private key material is equivalent to access to the underlying assets"; however, crypto assets are held on the blockchain and not by a custodian). *See also* PwC, Demystifying Cryptocurrency and Digital Assets, available at https://www.pwc.com/us/en/tech-effect/emerging-tech/understanding-cryptocurrency-digital-assets.html ("[T]he digital asset is stored on the blockchain ledger, and the keys that give you access to it are stored in a wallet"). While seemingly minor distinctions, it should be clarified whether one *actually* holds either private keys (as we contend) or crypto assets (as the Proposed Rule

private key material used to authenticate control over the assets allocated to a public address.[25]

A Crypto Custodian is responsible for safeguarding the private key material associated with crypto assets, rather than physically storing the crypto assets themselves. Unlike physical assets that can be protected through physical security measures, crypto assets are intangible and typically exist on a public blockchain with permissionless access that do not allow for the reversal of transactions. Crypto asset ownership and transfer are determined by control over the associated private keys, which are used to authenticate transfer instructions and must be kept secret to prevent unauthorized access. For the avoidance of doubt, we believe it is appropriate for a custodian to "custody" crypto assets by safeguarding private key material that can control those crypto assets.

Maintaining a private key secret is a challenge unique from physical security; however, crypto assets and public ledgers do not layer additional risks beyond those associated with private keys. To the contrary, distributed ledger technology allows for transparency and auditability that is unique from traditional asset classes. This auditability should allow greater, near real-time monitoring of Crypto Custodian arrangements to mitigate the risks of Adviser misappropriation.

Ultimately, the Proposed Rule should examine more closely the requirement to hold crypto assets with a Qualified Custodian, particularly given the fact that a Crypto Custodian secures private keys and not the underlying crypto assets.[26] We suggest that the Proposed Rule allow for greater

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appears to state), particularly for affirmative obligations such as segregation or liability. For example, how does one effectively segregate digital records. *See* footnote 26, *infra*.

From a non-technical perspective, when we say that a custodian holds crypto assets, we only mean that it holds private keys (or private key material). Prescriptive rules must remain flexible to allow for various technical functions while ensuring we do not mandate the shorthand assumption of how crypto asset custody works. We respectfully suggest the Commission revisit the language specific to crypto assets and ensure that rules are flexible to allow for various means of compliance.

[25] Within the crypto asset community, best practices for securing private keys have evolved significantly over the past 14 years. "Hot wallets" (networked computers holding private key files) were untenable once bitcoin gained real value, leading to "cold storage" (the maintenance of private keys on non-networked computers or physical media). Shortly thereafter, hardware security modules ("HSMs"), multi-signature wallets (where a quorum of multiple private keys are used to authorize a transaction from a public address), private key sharding (the segmentation of private key material for subsequent reassembly), multi-party computation (a system of sharing private key material among a quorum of linked computer devices) and other forms of asset control emerged as best practices. From a regulator's perspective, it is important to focus on core safeguarding principles without hard coding requirements. For example, the use of multi-party computation means that a Crypto Custodian may not have exclusive control or access to a full private key, due to sharding and quorum mechanics for the reconstitution of private key material.

The financial services industry has benefited from many of the technical innovations in cyber security and private key management that have been pioneered by the crypto asset industry. This is also true with regulatory innovation, including the cyber security regulations first imposed by the NYSDFS on "BitLicense" holders. *See*, *e.g.*, NYSDFS Cybersecurity Resource Center, available at https://www.dfs.ny.gov/industry_guidance/cybersecurity (NYSDFS first imposed cybersecurity regulations on virtual currency business licensees in 2015, as a precursor to "first in the nation" cybersecurity regulations to protect customer information at all financial institutions regulated by the agency).

[26] The Proposed Rule requires that an Adviser custody assets (including crypto assets) with a Qualified Custodian; however, crypto assets themselves are ledger entries on a distributed ledger and are not custodied by

technological and compliance flexibility, while clarifying that an Adviser's obligations are to satisfy the goals and safeguarding principles of the existing Custody Rule or the Proposed Rule, rather than a strict technical interpretation thereof.

B. *If the Proposed Rule's requirements are applied to crypto assets, the requirements should account for the unique elements of crypto assets.*

As a Crypto Custodian secures private keys and not the underlying crypto assets, asset segregation should be measured according to the appropriate policy goals and the specific technological implementations.

Private keys may be generated individually, but are more typically created through the use of a hierarchical deterministic structure through which a "seed phrase" is used to generate a specific set of private keys that are unique to the seed phrase.[27] In crypto asset custody, a seed phrase is typically entered into an HSM or computer device, with the hardware accessing the private keys derivative to the seed phrase. The Proposed Rule does not distinguish between whether segregation requirements are satisfied by allocating crypto assets to unique addresses, or whether a Qualified Custodian must segregate the private keys held by such custodian. It is our position that the former likely satisfies the associated policy goals. The use of hierarchical deterministic structures promotes security and operational efficiency, but we are concerned that a strict reading of the Proposed Rule could be interpreted to require segregation that interrupts the use of hierarchical deterministic structures or the use of singular devices to manage private keys.

Furthermore, the public, transparent nature of crypto asset networks provides certain material audit and verification benefits. While the difficulties of authenticating exclusive control over crypto assets have been acknowledged,[28] the traceability of crypto asset transactions allows for improved efficiency for verification of transactions and for Client oversight over crypto assets held in dedicated public addresses. These features may promote alternative regulatory structures for oversight and investor protections for crypto asset custody that satisfy the underlying policy objectives of the Custody Rule in a more efficient, transparent manner.[29]

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any party. Instead, a party manages private keys associated with these digital assets. As such, it is unclear if crypto assets are subject to the custody requirement under the Proposed Rule, or if such requirements are satisfied by custodying private keys associated with crypto assets.

[27] For a somewhat technical discussion of hierarchical deterministic wallets and structures, *see* Harsha Goli, HD Wallets Explained: From High Level to Nuts and Bolts, March 18, 2018, available at https://arshbot.medium.com/hd-wallets-explained-from-high-level-to-nuts-and-bolts-9a41545f5b0. The core principle that we seek to convey is that digital asset custody is not as simple as vaulting bitcoin or ether; it is the safekeeping of private keys which are often mathematically linked to each other. As a result, the technology raises questions of what is appropriate segregation and what asset is actually custodied.

[28] *See, e.g.*, Issues, Risks, and Challenges for Auditing Crypto Asset Transactions, International Journal of Accounting Information Systems, Vol 46, September 2022, available at https://www.sciencedirect.com/science/article/abs/pii/S1467089522000215.

[29] *See* Section IX.B, *infra*, regarding asset and transaction verification requirements under the Self-Custodial Exception (as defined below).

C. *The Proposed Rule would harm Clients by preventing Advisers from using reliable, third-party custodians.*

The present Crypto Custodian market includes a variety of reliable, well-regulated custodial players. These include Coinbase Custody Trust Company (a New York limited purpose trust company regulated by NYSDFS), Anchorage Digital Bank (a South Dakota company regulated by the Office of the Comptroller of the Currency) and Bitgo Trust Company (a South Dakota trust company regulated by the South Dakota Division of Banking). These entities have state of the art technology and practices and an exemplary record of securing crypto assets through the safeguarding of private keys using cold storage, multi-signature wallets, multi-party computation, and business continuity, backup and security systems. Clients benefit from the use of these third-party custodians; however, it is unclear if any of the above referenced Crypto Custodians qualify to be a Qualified Custodian under the Proposed Rule, or if they would be capable of complying with the Minimum Custodial Protections.[30]

The market for crypto asset trading platforms and Crypto Custodians is new with best practices and regulatory infrastructure continuously evolving. The Proposed Rule would drive Client assets from the protections of Crypto Custodians or make the use of Qualified Custodian Crypto Custodians prohibitively expensive, thereby (i) potentially eliminating the soundest and most technically developed solutions for safeguarding Client crypto assets in favor of institutions less equipped (and eager) to perform this function and (ii) increasing the risk that Client crypto assets are lost or misappropriated.[31] We believe that the Commission should defer application of the Proposed Rule to crypto assets, eliminate the Minimum Custodial Protections, and reconsider whether to require that an Adviser maintain crypto assets with a Qualified Custodian that has possession or control of the assets. In the alternative, the Commission should afford crypto assets the same exception from the requirement to use a Qualified Custodian as is available for physical assets.

D. *The Commission should extend the comment period to consider issues relating to the trading of crypto assets.*

As with Crypto Custodians, the market for crypto asset trading platforms and over-the-counter trading is emerging. At present, there are limited options to trade crypto assets from a custodial account that appears to comply with the Qualified Custodian requirements, and few trading facilities offer market participants settlement on a delivery-versus-payment basis.[32] It is possible that the crypto asset industry will develop such functions; however, this will take time and likely result in material costs and market inefficiencies. The imposition of the Proposed Rule as drafted

[30] We believe the Minimum Custodial Protections would drive participants from the Qualified Custodian market, reducing competition and investor choice. *See, e.g.*, footnotes 41 and 42, *infra*, and associated text.

[31] *See* Peirce Statement, which argues that the Proposed Rule's impact on crypto asset custody "could leave investors in digital assets more vulnerable to theft or fraud, not less."

[32] FINRA and the Commission have also failed to provide guidance on how broker dealers should interact with crypto assets. *See* footnote 12, *supra*.

may serve as a *de facto* ban on the use of the most prominent trading facilities; this would impact the quality of execution, increase transaction fees, and reduce the accessibility of markets and liquidity available to Clients, in each case materially, adversely impacting Clients.[33] We respectfully request that the Commission extend the comment period to allow greater input on these important issues.

VI. *The contractual requirements and reasonable assurances (collectively, the "Minimum Custodial Protections") required under the Proposed Rule are problematic and represent novel overreach into commercial activities and market standards.*

A. *The Minimum Custodial Protections are overly burdensome, reduce investor choice, limit market competition, and, if adopted, would not uniformly achieve the policy goals of the Proposed Rule.*

We have concerns that the Proposed Rule over-regulates commercial agreements involving the custody of Client assets. Specifically, the Minimum Custodial Protections described below foster indirect regulation of existing commercial agreements among parties (i.e., a custodian and an end client) that may not be regulated by the Commission, and at the same time seek to interpose Advisers in this relationship with new commercial agreements between Advisers and qualified custodians ("Qualified Custodians").[34] We have no doubt that the Commission seeks to provide protections to Clients, but the Proposed Rule has not demonstrated that (i) the Minimum Custodial Protections are reasonably necessary (or even beneficial) to meet the goals of reasonable investor protection or the prevention of Adviser misappropriation, (ii) the increased costs borne by both service providers and investors are outweighed by the benefits of the proposed safeguards,[35] (iii) it will not reduce the choice available in Qualified Custodians and the forms of service offered by such custodians, (iv) it will not reduce or even eliminate the availability of Qualified Custodians

[33] *See* Blockchain Association Letter and a16z Letter, which discuss potential negative impacts of the Proposed Rule while questioning the legality of such a *de facto* ban. The Blockchain Association letter cites the concern over a shadow ban on crypto asset trading facilitates expressed by Commissioner Mark Uyeda. Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets, February 15, 2023, available at https://www.sec.gov/news/statement/uyeda-statement-custody-021523. The a16z Letter also requests clarity on the ability of Advisers to utilize decentralized trading platforms to seek liquidity on behalf of Clients. We join this request.

[34] In addition to creating backdoor regulation of unregulated parties, the Contract Directive diverges from prior Commission practice of promulgating principles-based rules. Although the comment period has not afforded sufficient time for due inquiry, we cannot think of another proposed rule that required specific contractual language to substitute the judgment of the Commission in place of accepted industry practices and norms.

[35] The Proposed Rule cost-benefit analysis rarely seeks to address the actual cost of proposed safeguards, evidenced by the Commission's failure to quantify the actual cost; for example, when evaluating the cost-benefit of the indemnification protection, the Commission simply acknowledges (without quantifying) that there will be increased operational costs and cost of liability insurance. Instead of addressing this cost (or the difficulty in quantifying it) head-on, the SEC argues that such costs will be mitigated by custodians who already provide such safeguards, which leaves a market participant with little understanding of the actual costs. See Proposed Rule at page 289. The Proposed Rule also fails to adequately establish the basis for the assumption that custodians providing such safeguards do so across geographies and asset classes.

for certain assets, and (v) the Minimum Custodial Protections are capable of being enforced or of meaningful benefit to investors.

The Proposed Rule requires that an Adviser maintain Client assets with a Qualified Custodian pursuant to a written agreement between the Qualified Custodian and the Adviser,[36] in addition to requiring that the Adviser obtain certain reasonable assurances from the Qualified Custodian. This approach sets forth a heavy-handed adoption of custodial protections, which is inappropriately referred to as "Minimum Custodial Protections."[37] The Proposed Rule lists the following baseline protections as required to protect custodial customers when the Adviser has custody. The first five are provided as written reasonable assurances from the Qualified Custodian to the Adviser and the final five are incorporated into the proposed written agreement.

1. The Adviser must obtain reasonable assurances that the Qualified Custodian will exercise due care.
2. The Adviser must obtain reasonable assurances that the Qualified Custodian will indemnify losses caused by the Qualified Custodian's negligence.[38]

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[36] The Proposed Rule acknowledges that the typical existing relationship involves a commercial agreement between the Qualified Custodian and the Client. The Adviser does not typically have contractual privity with the Qualified Custodian, acting instead pursuant to authority directed by the Client to the Qualified Custodian. While acknowledging that this changes the typical contractual structure, the Proposed Rule does not adequately address the monetary or temporal cost to Advisers, Qualified Custodians and Clients of revamping the custodial structure and negotiating new market agreements. *See* footnote 49, *infra*. In some respects, it appears that this new agreement requirement and the Minimum Custodial Protections are little more than a means to capture regulatory control over the contractual arrangement between Qualified Custodians and Clients. While we believe that the Commission has not justified this new requirement in its cost-benefit analysis, if adopted, we request that the Commission consider imposing an extended transition period that adequately allows the market to adjust to this newly mandated *modus operandi*.

[37] The Proposed Rule does not identify or discuss what protections the Commission considered and whether it specifically elected to not include any such protections within the "Minimum Custodial Protections"; it appears from the Proposed Rule that the Commission includes every possible protection that it could summon. We would be curious as to what protections the Commission excluded and the rationale for such decision. As is, the Proposed Rule seeks to insulate Clients from losses without demonstrating that these risks are, in fact, both material and capable of being prevented by the Minimum Custodial Protections. To the contrary, we fear these provisions will provide little actual benefit to Clients, while imposing material new costs and resulting in custody and sub-custody market exodus. These costs and contractions are likely to hit foreign and non-standard asset classes more significantly than traditional US equities and debt markets, and may have a greater impact on traditionally underserved investing communities. *See* footnote 43, *infra*.

[38] Although liability standards vary across geographies and asset classes, the Proposed Rule materially departs from existing market conditions. The Commission argues that indemnification for loss on a simple negligence standard would create a baseline where the most vulnerable clients (presumably the Commission intends this to mean retail managed accounts) are afforded the benefits of greater negotiating power; however, the negligence standard imposed by the Proposed Rule is not standard for Clients of any negotiating power across geographies or markets. The Proposed Rule notes that the Staff "has observed that custodians often include indemnification clauses in their custodial agreements" (at page 87); this is not the same as quantifying what percentage of the market includes indemnification provisions or identifying the typical the level and nature of indemnification coverage. *Arguendo*, if one accepts that certain corners of the custodial market are willing to accept tighter liability standards, one must understand that liability provisions are not – and *should not be* – standard across

3. The Adviser must obtain reasonable assurances that the Qualified Custodian's use of sub-custodians will not obviate the Qualified Custodian's obligations to, and indemnification of, the custodial client.[39]
4. The Adviser must obtain reasonable assurances that the Qualified Custodian will segregate client assets from the Qualified Custodian's assets.[40]
5. The Adviser must obtain reasonable assurances that the Qualified Custodian will not encumber client assets except where authorized in writing by Client.
6. The Qualified Custodian must agree in writing to certain recordkeeping requirements.
7. The Qualified Custodian must agree in writing to cooperate with accountants to assess safeguarding efforts.
8. The Qualified Custodian must agree in writing to provide the client account statements.
9. The Qualified Custodian must agree in writing to provide appropriate internal control reports, reviewed periodically.

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markets. For example, the unique characteristics of local markets, custodial operations and asset characteristics are all material considerations for Henry Bath when it custodies copper cathodes in Antwerp, Marathon Petroleum when it holds crude oil in Canton, Ohio, HSBC when it custodies precious metals in London, Brinks when it vaults diamonds in New York City, Coinbase Custody when it secures private keys in facilities distributed around the globe, or the tens of thousands of off-farm grain storage facility operators across the US. It is not rational to pre-define contractual terms for these custodians in a manner uniform to the simpler securities custody operations or highly regulated banking relationships. It is also not fair to impose these standards on industrial custodians who do not typically service customer accounts managed by Advisers; which would likely impose particularly harsh burdens and limit the ability of advised Clients from allocating capital to industrial sectors for fear of impossible or hard to find custodial services.

[39] The Proposed Rule mandates that a Qualified Custodian be responsible for the actions of a sub-custodian engaged by it. This is a significant departure from existing standards, which we believe require that a custodian either reasonably select or exercise due care in selecting the sub-custodian. Our interpretation of the Proposed Rule is that the Qualified Custodian may have liability for relying upon a sub-custodian to hold assets, even if the Qualified Custodian has taken reasonable measures and exercised due care in selecting the sub-custodian. If our interpretation is correct and the Proposed Rule is adopted in current form, we have zero doubt that this requirement will result in (i) reduced services offered by custodians, (ii) reduced use of sub-custodians, (iii) mayhem as existing custodial agreements seek to address this new regulator mandated risk shifting, and (iv) increased costs being passed on to end Clients. Importantly, Clients will be required to engage directly with new custodians to hold assets that principal custodians may not directly hold. For example, it is probable that US investors will find it far more costly and difficult to gain exposure to foreign equity markets, reducing US investment in emerging markets such as sub-Saharan Africa, Southeast Asia and other developing regions in which local sub-custodians are relied upon to custody equities, commodities and other assets.

[40] While we are generally supportive of segregation of customer assets, we note that exceptions should be permitted. Some assets are more difficult to segregate. For example, precious and industrial metals custody arrangements typically rely on joint-balancing accounts to allocate ownership of the final bar, cathode or bag through a jointly owned account. Similarly, a Client acquiring an interest in bushels of grain or barrels of oil would not necessarily expect to have full segregation of every bushel in a silo or barrel in a terminal. There may be certain instances where particular assets must be commingled temporarily to facilitate movements, transfers or other activity that is to the benefit of the end Client. We ask that the Commission consider what circumstances and exceptions are warranted to the segregation mandate.

10. The Qualified Custodian must agree in writing to the Adviser's agreed-upon level of authority to effect transactions on behalf of the Client in the account.

The SEC acknowledges that the written agreement and the reasonable assurances providing most of the ten significant protections are a substantial departure from industry practice; however, the Proposed Rule does not adequately justify the leap between the problems the Commission seeks to address and the solutions it proposes. We believe these substantial departures are overly burdensome and will cause a reduction of services and service providers. Other commenters including the U.S. Small Business Administration also have expressed concerns with the increased costs on industry participants and question the sufficiency of the Commission's justification for the Proposed Rules.[41] Industry contraction will reduce investor choice, limit market competition, and would not uniformly achieve the policy goals of the Proposed Rule – that is to say that these Minimum Custodial Protections are largely not targeted with preventing Adviser misappropriation; the provisions instead appear intended to grant the Commission with indirect regulatory authority over Qualified Custodians.

Industry contraction and reduced investor choice would adversely impact smaller market participants and reduce the custodial options available to Clients.[42] The increased compliance, legal, regulatory and risk costs associated with custodial contracts will ultimately result in increased costs to Clients, with many custodians, sub-custodians and Advisers reducing services offered or exiting markets entirely. It is possible – if not probable – that this market contraction and passing on of increased costs will have a greater impact on underserved investor communities[43] and on non-standard asset classes.[44]

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[41] Comment to File No. S7-04-23 from the Office of Advocacy, US Small Business Administration, May 5, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-184679-338462.pdf (arguing the Proposed Rules would have a disproportionate impact on smaller market participants and highlighting that the Initial Regulatory Flexibility Analysis understates the proposal's impact and does not consider alternative regulatory options) ("SBA Letter").

[42] *Id*. (The Small Business Administration Advocacy group "urges SEC to consider the potential market consolidation that could result from the proposed rules, and the impact that consolidation would have on advisers and investors").

[43] We believe that the Proposed Rule should do more to study the impact on underserved markets. We suspect that communities that are historically underserved by financial institutions will be more significantly impacted by market constrictions and the higher costs of custodial services. A 2021 report indicates that FinTech firms expanded financial inclusion by delivering services with lower costs to underserved communities; increasing compliance and regulatory costs could reverse this progress. Deloitte, Driving Purpose And Profit Through Financial Inclusion, March 30, 2021, available at https://www2.deloitte.com/us/en/insights/industry/financial-services/purpose-through-inclusive-finance.html. While the Proposed Rule's stated purpose is to enhance the protections afforded to Clients with less bargaining power, the practical effect may be to further reduce the number of companies serving the most vulnerable investing communities.

[44] Underserved markets also include asset classes that are esoteric or non-standard, typically as a result of market size or the industrial foci of these asset classes. While this rule seems targeted at crypto asset markets and seeks to reshape the structure of crypto asset trading platforms and over-the-counter trading facilities, securities markets norms may also be foreign to hard commodity and collectible markets. For some non-traditional asset classes, investment dollars play an important role in providing capital or for commercial and industrial supply

B. *The Proposed Rule fails to consider that all Clients are not similarly situated; we should not uniformly adopt regulations that would constrict the investment activities of certain Clients, such as private funds, on the basis of the Staff's observations, anecdotal market data, and loosely documented perceptions of the retail investor experience.*

The Proposed Rule does not adequately contemplate or justify the adoption of the Minimum Custodial Protections for private funds advisers. Instead, it focuses solely on one cadre of Clients (retail managed accounts) and fails to address the concerns or needs of the private fund markets. This is a marked departure from past practices of the Commission, which historically has acknowledged that the investing public is not uniformly situated and that certain investors may be better suited to assess and take on risks.[45]

The Commission has long held that market participants may engage with and sell to parties that meet accredited investor or qualified purchaser standards (including institutional investors and investment professionals) without some of the restrictions that are required for retail investors. This includes the availability of registration exemptions for private placements under the Securities Act of 1933[46] and Investment Company Act of 1940[47] as well as past examples in which the Commission has expressly excepted accredited investors, qualified purchasers or other institutional investors from enhanced disclosure requirements and other investor protection.[48]

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buffers. Rules that restrict private investment could disrupt this and result in negative commercial repercussions. While the Self-Custodial Exception may reduce the impact of the Proposed Rule on these markets, the Minimum Custodial Protections could have far reaching implications.

[45] We applaud the Commission's recent efforts to modernize the accredited investor standard. Updating the Accredited Investor Definitions, File No. S7-25-19, available at https://www.sec.gov/rules/final/2020/33-10824.pdf (Aug. 26, 2020). At the same time, we express concerns that a standard largely dependent upon net worth is an imperfect means of measuring the ability to assess disclosure and risks in investments. *See, e.g.*, testimony from the House Financial Services Committee Hearing Entitled: Sophistication or Discrimination? How the Accredited Investor Definition Unfairly Limits Investment Access for the Non-wealthy and the Need for Reform, February 8, 2023, available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408510.

[46] 17 CFR § 230.506.

[47] 15 U.S. Code § 80a–3(c).

[48] For example, in the proposing release for Use of Derivatives by Registered Investment Companies and Business Development Companies, the Division of Investment Management highlighted that even retail investors could be granted access to risky (at least on a relative basis) daily delivered investment products because sales practice rules require that a broker-dealers or investment advisers "reasonably believes [investors] have such financial knowledge and experience that they may reasonably be expected to be capable of evaluating the risk of these funds." Release No. 34-87607, File No. S7-24-15 at page 33, available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf. The release highlights that promoting investor choice was a priority when considering leverage limits for funds. The subsequent adopting release championed commitment to investor choice, together with risk disclosure, stating that the Commission was "committed to designing regulatory programs that reflect the ever-broadening product innovation and investor choice available in today's asset management industry…." Release No. IC-34084; File No. S7-24-15 at page 5, available at https://www.sec.gov/rules/final/2020/ic-34084.pdf (November 2, 2020). Notably, the final rule eschewed the enhanced sales practice rules identified in the proposed rule, instead relying on Regulation Best Interest

We believe that the Proposed Rule comment period should be extended and the text of the rule reconsidered to account for the impact of the Minimum Custodial Protections on private funds and the accounts of non-retail investors. We believe that custodial arrangements and other instances of counterparty and legal risk are matters that are better suited for disclosure, rather than contract language mandates.

C. *The Proposed Rule fails to provide evidence that the Minimum Custodial Protections – which impose significant burdens and costs on market participants and investor clients – address a material issue or problem generally (and for private funds specifically), or that the measures proposed would have a material positive impact in addressing any such material issue or problem.*

The SEC has identified the following issues that the Minimum Custodial Protections seek to address: (i) inadvertent custody, (ii) inadequate protections for crypto asset-related custodial activities, (iii) Qualified Custodians contractually limiting their liability, (iv) the outsourcing of certain Qualified Custodian obligations to sub-custodians, and (v) the imbalance of Clients with the least bargaining power receiving the least contractual protections. We are concerned that the Commission has failed to establish the materiality of these problems, that the solutions proposed adequately address these problems, or that the Proposed Rule's adoption costs do not outweigh the perceived problems.[49]

The Proposed Rule points to inadvertent custody as a justification for implementing a written agreement between the Adviser and the Qualified Custodian, but it does not consider (i) how widespread of a problem inadvertent custody is and (ii) whether it is also an issue for private fund advisers.[50] Custodial agreements that grant an Adviser expansive authority to transact in or transfer

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requirements on broker-dealers and the fiduciary duty of investment advisers to ensure that retail investors were protected. *Id.* at page 10.

The Commission has not demonstrated in the Proposed Rule why custodial arrangement – specifically the contractual liability provisions included therein – are considered more risky or harder to comprehend than complex, daily resetting leveraged investment products. Nor has the Commission demonstrated why sophisticated investors (including private fund Clients and their underlying accredited or qualified purchaser investors) are not capable of weighing the risks associated with custodial accounts.

[49] We are also concerned that the Proposed Rule significantly underestimates the associated cost of adopting the proposed written agreement. For example, the Proposed Rule estimates that the Adviser "will incur an internal burden of 1 hour [] to prepare the written agreement", which grossly underestimates the amount of time in-house counsel, working with external counsel, will dedicate to draft and finalize the written agreement. This concern is shared by the US Small Business Administration, which specifically cites this underestimation for both large and small Advisers. *See* SBA Letter. Moreover, the Proposed Rule estimates that future changes will, on average, take 10 minutes to modify. Such an estimate does not consider the nature of contract negotiation and the evolving nature of additional provisions both the Adviser and the Qualified Custodian will add to such contracts as litigation results and subsequently resolves.

[50] In February 2017 the SEC's Division of Investment Management provided guidance stating that an Adviser may be deemed to have custody of Client funds or securities when a custody agreement between a Client and a custodian grants an Adviser greater access to the Client funds or securities than the Adviser's agreement with the Client - this situation is referred to in the guidance as "inadvertent custody". See *Inadvertent Custody:*

assets held in custodial accounts are generally a problem that exists outside of private funds (as opposed to retail). Advisers that manage private funds automatically have custody of client assets and therefore inadvertent custody is not appropriate to justify the adoption of Minimum Custodial Protections for private funds. Accordingly, the SEC should consider excluding private funds from the Minimum Custodial Protections requirement.

Beyond private funds, we question whether implementing Minimum Custodial Protections within a written agreement as a blanket solution for all Advisers is appropriate without fully exploring and understanding the scope of the problem being addressed or the consequences of the solution.

Second, the SEC's concern regarding inadequate protections by crypto asset custodial services is also an insufficient justification. The Commission has historically adopted an asset neutral approach and does not seek to weigh in on the merit of one asset class over another. The risks relating to the custody of crypto assets are a question of disclosure and suitability, rather than one of merit.[51]

Third, the Proposed Rule fails to reconcile its acknowledgment that Qualified Custodians are currently contractually limiting their liability to stay profitable, on the one hand, with its requirement that Qualified Custodians indemnify clients for losses caused by their simple negligence, on the other. The Commission has not explained how Qualified Custodians that are pulling back from providing indemnification protections in order to remain in business will provide indemnification, *deus ex machina*. Nor does the Proposed Rule reckon with the added costs this indemnification obligation will impose on end investors.[52] A revised Proposed Rule must acknowledge the practical implications of the Minimum Custodial Protections.

Advisory Contract Versus Custodial Contract Authority, February 2017, available at https://www.sec.gov/investment/im-guidance-2017-01.pdf. The inadvertent custody guidance did not point to any actual harm that occurred as a result of inadvertent custody, in large part, we imagine, because Advisers rarely knew they had custody in these situations. Given that the Commission identified inadvertent custody more than six years ago, we would expect the staff to better understand and articulate in the Proposed Rule, what, if any, harm resulted from Advisers that held Client funds or securities pursuant to inadvertent custody.

[51] We acknowledge the unique characteristics of crypto assets prevent an apples-to-apples comparison with the custody of equity and debt securities and many other forms of custody. *See* Section V, *supra*. Nevertheless, these risks are not existential and investors may make informed decisions regarding the asset class and service providers available to it. Furthermore, making this asset class unavailable to Adviser managed accounts will reduce investor protection, on the whole.

[52] We are presently witnessing a reckoning of the costs of indemnification in the specter of ongoing bank failures. The Federal Deposit Insurance Corporation ("FDIC") backstops up to $250,000 / $500,000 in depositor accounts through an insurance pool funded by assessments on bank accounts. Although there is high demand for an increase in the deposit limits receiving FDIC coverage, material expansion of coverage would result in significant assessment increases and could alter the market dynamics (e.g., bank risk-taking). FDIC Releases Comprehensive Overview of Deposit Insurance System, Including Options for Deposit Insurance Reform, May 1, 2023, available at https://www.fdic.gov/news/press-releases/2023/pr23035.html. In the report, the FDIC recommends a targeted approach to adjust insurance needs based on account types and risks. We encourage the Commission to heed the FDIC's parallel restriction and understand that blanket decisions to shift risks and change market accepted liability terms can have both economic and market practice implications.

Fourth, the Proposed Rule fails to explain why its concern for those who are least likely to have bargaining power should result in a heavy-handed adoption of Minimum Custodial Protections for all market participants, including those that do have bargaining power (such as private funds or other non-retail accounts) to negotiate an arm's length commercial contract. The Clients with the least amount of bargaining power are those with the least amount of assets, and, if the Minimum Custodial Protections remain in the Proposed Rule, the SEC should consider limiting their imposition to Clients that hold less than a certain amount of assets.[53] This would allow larger Clients to negotiate their own terms, conditions, and protections. This approach could alleviate the impractical requirement that Qualified Custodians provide insurance for all Client losses since the SEC could limit the rule to only require Qualified Custodians to insure assets of individuals who have less than a certain amount of assets, making it more likely for custodians to secure insurance coverage for these assets.[54]

The aforementioned reasons for adopting the proposed Minimum Custodial Protections fail to independently or in the aggregate justify the heavy-handed adoption of custodial protections. Without more evidence that the Minimum Custodial Protections address a material issue or problem generally (and for private funds specifically), or that the measures proposed would have a material positive impact in addressing any such material issue or problem, the Commission should abandon the proposal of these concepts.

D. *In the event the Proposed Rule is adopted, we believe it should eliminate the Minimum Custodial Protections and adopt instead a risk disclosure regime provided to the Client by the Adviser*.

The Proposed Rule seeks to improve the safekeeping of client assets by requiring Advisers to obtain reasonable assurances in writing from the Qualified Custodian acknowledging it will comply with the client protections required in the Proposed Rule. However, the reasonable assurances construct is an ineffective and meaningless investor protection framework. Accordingly, for the reasons stated below, we recommend that the Commission adopt a risk disclosure regime consistent with the Commission's long-standing reliance on disclosures as the ideal framework that ensures investor protection while promoting competition and investor choice. We believe that this risk disclosure framework is a less burdensome and more appropriate

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[53] In the alternative, the Commission could seek to ladder the protections, such that only up to a set threshold of assets are required to be indemnified. This structure mimics FDIC and Securities Investor Protection Corporation limits, which would allow Qualified Custodians to better control and estimate their liability risks. It is our understanding that Qualified Custodians already seek to limit exposure through provisions that cap potential liability, often to the fees actually paid under a custodial contract.

[54] The Commission has expressed a concern that pension funds are heavily invested in private funds and, as a consequence, that individual investors' retirement assets are at risk via these private fund investments; however, pension funds are sophisticated investors that do not require the same protections as individual retail investors. Undertaking a standard that looks through the pension fund to the individual investor ignores this level of sophistication and the access to investments that pension funds have (that individuals do not) based upon this level of sophistication. Furthermore, the Employee Retirement Income Security Act provides certain heightened management and disclosure obligations relating to pension and retirement accounts. 29 U.S.C. Chapter 18.

safeguard for investors, which mirrors the Commission's historic reliance on disclosures to inform investors of the risks related to their investments.

The reasonable assurances framework does not provide any actual legal protection or cause of action for the Adviser or its Client. In the event a Qualified Custodian fails to implement the protections of which it reasonably assured an Adviser, it is unlikely that the Adviser or the custodial client can then sue the Qualified Custodian for failing to provide such protections. The reasonable assurances are meant to protect against custodial misconduct, however, in the face of custodial misconduct it is more likely that Advisers will receive meaningless written assurances. Ironically, under the reasonable assurance framework, the Client, whom the SEC is trying to protect, may not have any recourse against the Qualified Custodian in the event of misappropriation of Client assets or bankruptcy of the Qualified Custodian (the Client cannot leverage, monetize, or otherwise bring a cause of action based upon the reasonable assurances the custodian provided the Adviser, rendering the reasonable assurances effectively meaningless); the reasonable assurance framework therefore adds no additional protection and Clients must rely on existing contractual rights.

Although we do not believe that the Minimum Custodial Protections should be adopted, we do believe - in keeping with the Commission’s disclosure-based framework - that, if adopted, the Minimum Custodial Protections should be optional as long as the Adviser discloses to the advisory client in writing either (i) which protections are or are not included in the custodial agreement or (ii) adequate summaries of the functions of custodial agreements and their attendant risks.[55] By doing this the custodial/advisory client receives disclosure concerning which of the SEC recommended Minimum Custodial Protections are actually included in the custodial agreement and can therefore decide whether or not it wants to move forward with an advisory relationship that includes that specific custodian (if a standard form is used to disclose and list which protections are used it would make it easier for the custodial/advisory client to compare which custodians provide different protections).

Providing disclosure as to whether or not the reasonable assurances protections are included in the custodial agreement ensures that the Client (i) is informed whether or not the custodial agreement includes certain protections and (ii) is more likely to be aware of its rights under the custodial agreements and their ability to enforce a breach of contract claim.[56]

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[55] We propose amendments to Form CRS to incorporate such disclosure in Section VIII, *infra*.

[56] We also considered whether it would be appropriate for the Proposed Rule to require that an Adviser ensure that the Minimum Custodial Protections be included in a Client’s custody agreement with a Qualified Custodian; this could be tied to an Adviser’s fiduciary duty or specifically mandated as a requirement before providing or continuing to provide advisory services. We strongly oppose such a mandate as this would functionally require that an Adviser provide legal services to a Client (i.e., advising on the contractual rights under a legal contract). Advisers are not positioned to provide legal services, nor have legal services ever been a standard part of the advisory services landscape. Instead, disclosure regimes that provide higher level risk assessments and mechanical explanations fall within their remit.

E. *In the event the Proposed Rule is adopted consistent with its current form, we believe it should include an exception to exclude private funds from the Minimum Custodial Protections*.

As mentioned above, we believe that private funds should be excluded from both the reasonable assurances and the written agreement requirement. The Proposed Rule does not consider private funds in any of the stated reasons provided by the Commission as a justification for the adoption of Minimum Custodial Protections. As noted above in Section VI.B., the Commission has historically provided investors in private funds with a different path (for example, the Commission has historically relied heavily on disclosure in the private fund context while allowing private fund investors to take greater risks (by ensuring the investors were sophisticated), and allowing private funds to satisfy the Custody Rule through the audit exemption). In the event that the Proposed Rule is adopted in its current form, we encourage the Commission to exclude private funds from the Minimum Custodial Protections.

F. *In the event the Proposed Rule is adopted consistent with its current form, we believe it should eliminate the reasonable belief requirement as an unnecessary and redundant measure*.

It appears as though the Proposed Rule adopts the reasonable belief principle as a concept that ensures that the Adviser is effectively monitoring whether or not a Qualified Custodian is, in fact, fulfilling its obligations pursuant to the custodial agreement. We object on the following grounds.

First, the reasonable belief requirement is redundant given that the vast majority of commercial parties enter into a contract based upon the belief that the other party is capable of, and intends to, comply with the contractual provisions; but for this belief, commercial parties would never enter into a commercial contract.[57]

Second, the concept of monitoring whether advisory client service providers are fulfilling their contractual obligations is a slippery slope (will the Commission subsequently require that Advisers have a reasonable belief that individuals with a power of attorney on behalf of Clients are fulfilling their obligations, or if attorneys, tax professionals, financial planners, or other individuals or institutions who may misappropriate Client funds are fulfilling their obligations).

Finally, the Commission should consider the difficulty in enforcing whether a reasonable belief exists; although data beyond anecdotal evidence is elusive, we believe it has been difficult, for example, to counter an Adviser's representation that it had a reasonable belief that a Qualified Custodian was sending account statements on a quarterly basis.[58]

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[57] As noted in the Proposed Rule, "advisers should enter into a written agreement with a qualified custodian based upon a reasonable belief that the qualified custodian is capable of, and intends to, comply with the contractual provisions. The adviser should have the same reasonable belief regarding the reasonable assurances obtained from the qualified custodian." Proposed Rule at page 81.

[58] The proposed requirement is similar to the approach in the current rule with regard to the investment adviser forming a reasonable belief after due inquiry that the qualified custodian sends account statements, at least

VII. *In the event the Proposed Rule is adopted consistent with its current form, we believe blanket indemnification provisions should not be required for all custodial agreements*.

We believe that the proposed indemnification standard is a substantial departure from current market practices across most asset classes, including with respect to the maintenance of insurance to backstop indemnification obligations.[59] The Commission is attempting to guarantee that an investor can only lose money as a result of a bad investment, but should not lose money based upon the intermediaries the investor uses to make such investments.[60] At no point does the Commission consider and or differentiate if private funds are able to understand the risk of loss or if it makes sense to provide certain "appropriate" protections for retail investors to private funds (the rule is driven by a policy of implementing the safeguard that protects the most at risk investor (retail), which is then applied to all investors). This is a departure from the Commission's historical

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quarterly, to the client. *See* Rule 206(4)-2(a)(3), available at https://www.ecfr.gov/current/title-17/chapter-II/part-275/section-275.206(4)-2.

[59] The Proposed Rule makes passing reference to the disconnect between the Minimum Custodial Protections and the current market, acknowledging that indemnification provisions generally do not call for custodians to make Clients whole, except where the losses are due to gross negligence or other material bad acts. The Proposed Rule does not adequately account for the diversity of risk considerations between asset classes and across geographies. If investors value greater indemnification at an increased cost, then custodians will see an increased demand for such services and custodians who do not provide broader indemnification standards will experience reduced demand for their services.

Furthermore, the Proposed Rule does not sufficiently address the vast differences in availability, quality and scope of insurance coverage for different asset classes and different geographies. For example, cash deposits benefit from FDIC and SIPC insurance, with supplemental deposit insurance available at marginal additional costs. Broker-dealers and futures commission merchants have robust insurance programs that have developed to serve this long-standing market. Banks similarly have access to robust insurance procedures for the custody of vaulted assets. But industrial warehouses, agricultural storage facilities and crypt asset custodians all secure assets that are subject to differentiated risks from fiat or securities accounts; insurance markets reflect those different risks. *See* CCI Letter for a discussion of the challenges indemnification presents for Crypto Custodians. The Proposed Rule neither sets forth clear guidance on what "insurance arrangements… to adequately protect" means, nor does it acknowledge that insurance may not be commercially feasible or available equally for all asset classes or geographies.

[60] The driving force behind the Commission's proposal is its concern that "investors, and particularly retail investors, understand that they may have limited recourse against the financial institution that was hired to safeguard their assets in the event they suffer a loss because of that institution's misconduct" and that "retail investors appear to have limited ability to negotiate [indemnification] terms effectively. Proposed Rule at page 87.

In the context of clearinghouse structures, markets accept the socialization of and insurance against loss to ensure the adequate function of exchange and derivative markets. This clearing structure ensures settlement and fulfills the pillars of promoting capital formation, investor protection and, importantly, fair and efficient markets. The clearing structure is also a response to a demonstrable need – in the absence of clearing structures, counterparty risk and failure could prevent the orderly and cost-efficient flow of markets. The Proposed Rule presents no evidence that contractual provisions limiting the liability of custodians (or other elements of the Minimum Custodial Protections) present a risk similar to those that spurred clearinghouse structures.

approach for private funds, which generally provided a separate standard and path to ensure the safety of client assets, including, but not limited to, the private fund exemption.[61]

The Proposed Rule also provides a cursory acknowledgment that Qualified Custodians may find it challenging to provide indemnification protection, especially for Crypto Custodians or custodians for some hard commodities. An extended comment period would be helpful to further explore the indemnification standards and associated custody risks for crypto assets and other commodities, as well as the insurance available to these markets. On information and belief, crypto asset insurance coverage is limited in scope of losses and services covered, number of underwriters, and amount of total coverage. For example, the largest Crypto Custodians typically have assets under custody that far exceed insurance limits, and such insurance does not cover all areas of loss, including loss due to simple negligence. It is unclear how a Qualified Custodian can satisfy the requirement to maintain insurance arrangements to adequately support Client indemnification. Given the divergence from market standards, the insurance requirements would likely result in significant additional cost, which would either be directly passed on to Clients or result in both traditional custodians and Crypto Custodians withdrawing from the Qualified Custodian market.

VIII. *The Proposed Rule should replace the Minimum Custodial Protections with a disclosure regime for retail customers that expands Form CRS.*

The Proposed Rule should be redrafted to incorporate amendments to Form CRS that enhance disclosure of custodial practices, on the one hand, and eliminate the Minimum Custodial Protections that threaten custodial markets, on the other.[62] A modified Form CRS, which is already designed to provide retail investors information through disclosure to easily compare different services,[63] could include a summary of the function of custodial arrangements and the attendant risks. This more practical and less expensive solution achieves the policy goals of the rule by providing transparency to Clients while preserving investor choice and market competition. This approach is a less disruptive measure that is more in line with the historical practices of the

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[61] *See* Footnote 14, *supra*, which includes final and proposed rules such as the amendment to Form PF, which impose disclosure requirements on private funds that are separate and distinct from disclosures provided to retail investors in Form CRS. Moreover, retail investors cannot invest in private funds unless they meet certain thresholds as either Accredited Investor, Qualified Client, and Qualified Purchaser. See definition and requirements for Accredited Investor, Qualified Client, and Qualified Purchaser at 17 CFR 230.501, 7 CFR 275.205-3, and 17 CFR 270.2a51-1. See also Private Fund Exemption, Rule 206(4)-2 under the Investment Advisers Act of 1940.

[62] The Commission clearly considered, as a viable alternative, relying upon disclosure to inform clients “that they could lose their assets in the event of custodian misconduct” by requesting public comment on this very topic. *See* Question 58 of Response Letter at 107.

[63] The SEC has stated that the Form CRS “relationship summary is intended to promote transparency, comparability and better-informed decision-making, through clear, concise disclosures, and by summarizing in one place selected information about a particular firm. This format is designed to allow retail investors to more easily compare different firms’ services, fees, conflicts of interest, disciplinary history and other important information.” See *Staff Statement Regarding Form CRS Disclosures* available at https://www.sec.gov/news/statement/staff-statement-form-crs-disclosures-121721.

Commission and would allow investors to assess risk and receive the benefit of their bargains.[64] As Chair Gensler has stated, "investors get to decide which risks to take," while the Commission and the federal securities laws simply seek to ensure that information is adequately disclosed.[65] This satisfies all three pillars of the SEC's mission and reduces information asymmetry.[66]

IX. *The Proposed Rule's changes to the privately offered securities exception (the "Self-Custodial Exception") should be revised to be flexible while focusing on core protections.*

A. *The Proposed Rule should retain the privately offered securities exception of the existing Custody Rule without modifications.*

The Commission has failed to provide any data that supports a need to implement additional protections for privately offered securities and, therefore, should retain the current exception of the Custody Rule without modifications. The Staff in the Division of Examinations has performed asset verification of private fund advisers over the past decade, including the verification of privately offered securities and, therefore, the Commission should have data evidencing that asset verification of privately offered securities is or is not useful in preventing and/or identifying misappropriation of privately offered securities by an Adviser. The Proposed Rule does not incorporate data on whether the Staff's asset verification efforts identified a crisis of private securities misappropriation, or whether or not (and how often) asset verification has actually identified misappropriation.[67]

It is our understanding that the asset verification program of the Commission rarely, if ever, has uncovered misappropriation of client assets; if it has, it would be useful for the Proposed Rule to discuss this data as a justification for the adoption of additional protections, which will require the dedication of significant Adviser resources. But for any data supporting that additional protections for privately offered securities are needed, the Commission is solving a problem that does not exist

[64] *See* Section I, *supra*, and the discussion of the Commission's use of disclosure regimes to provide investor protections. We note further that the Federal Securities Laws are not intended to eliminate risk, whether such risk is driven by investment risk or counterparty risk. Amending Form CRS would permit broker dealers and Advisers to deliver important information to retail investors in a forum that already exists and in a medium that is familiar. For more sophisticated or institutional investors, including private funds, risk disclosure is also accessible and is already capable of addressing counterparty and custodial risks.

[65] Footnote 4, *supra*.

[66] *See* Section II, *infra*, including references to Chair Gensler and former Chair Clayton's support for disclosure-based regimes that promote investor choice.

[67] During standard examinations of Advisers, the Commission has historically performed asset verification of private fund holdings. In conducting this asset verification, SEC examiners often rely on the procedures of the fund's Accountant to test asset existence. The examiners often inquire whether or not the Accountant verified 100% of the assets held by the private fund or if the Accountant relied upon a sampling methodology. The Accountant's procedures for asset verification may involve reviewing cash movements, bank statements, subscription documents and submitting and reviewing ownership confirmation forms sent to the management of the fund's holdings.

and imposing a far more costly solution than the existing reliance on mitigation measures, including the use of independent public accountants ("Accountants").[68]

The Staff's prior and ongoing reliance on Accountants for asset verification of privately offered securities – without any indication that the current framework is resulting in or encouraging misappropriation of client assets – supports the conclusion that the existing Custody Rule (both the private fund exemption and the privately offered securities exception) provides sufficient and effective safeguards that prevent the misappropriation of privately offered securities by an Adviser. The Proposed Rules new requirements impose significant new costs, such as prompt verification of holdings and transactions that will not meaningfully enhance the protections offered by periodic or annual Accountant reviews.[69]

Moreover, under the existing Custody Rule, certain private funds may not undergo an annual audit, which therefore requires that privately offered securities owned by the private fund be maintained with a Qualified Custodian. Accordingly, the Commission should already have data that private funds that maintain privately offered securities with Qualified Custodians are, in fact, less susceptible to misappropriation by the Adviser. Again, but for the existence of data supporting a material increase in the protection of privately offered securities, the Proposed Rule should not modify the privately offered securities exception of the Custody Rule, other than expanding the availability to physical assets and crypto assets under the Self-Custodial Exception concept discussed below.

B. If adopted, the Proposed Rule's notification requirements for asset verification under the Self-Custodial Exception should be dramatically scaled back.

In the event the Commission adopts the modified Self-Custodial Exception set forth in the Proposed Rule, we believe that the notification requirements for asset verification safeguards should be scaled back as unduly burdensome, impractical, resource intensive, costly, and/or problematic.[70] The exception to maintaining assets with a Qualified Custodian requires the Adviser to enter into a written agreement with an Accountant and requires (i) that the Adviser notify the

[68] For an Accountant's discussion of verification procedures, *see* Comment to File No. S7-04-23 from Deloitte & Touche LLP, May 3, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-183280-336642.pdf ("Deloitte Letter"). The Deloitte Letter also provides important context on internal control reports and the availability of Accountants capable of assessing crypto asset-related operations.

[69] Notably, the Proposed Rule requires that an Adviser trigger a review of private security or physical asset transactions for prompt verification. As the Proposed Rule seeks to mitigate Adviser misappropriation and fraud, it is unclear why the Proposed Rule believes that a fraudster will provide the trigger for Accountant review of its misappropriation, or why a private security that is not a bearer instrument requires near immediate verification. The Proposed Rule will impose enormous new costs on Advisers and greatly increase the cost of engagement of Accountants, which cost is almost uniformly borne by Clients.

[70] The Proposed Rule builds on the existing Custody Rule's privately offered securities exception, allowing Advisers to self-custody both privately offered securities and physical assets. Other commenters have called for an expansion of the Self-Custodial Exception to allow Advisers to self-custody any assets that cannot be reasonably held with a Qualified Custodian. *See, e.g.,* a16z Letter. We agree with these comments.

accountant of any purchase, sale, or other transfer of beneficial ownership of such assets ("Transfer") within one business day and (ii) that the Accountant verify the Transfer and notify the Commission within one business day upon finding any material discrepancies.[71] The Commission believes that these protections provide "meaningful and much-needed protection" when the Adviser has client assets that are not maintained by a Qualified Custodian. We take issue with both requirements.

The requirement to report within one business day any Transfer is unduly burdensome and would require auditors to significantly increase their personnel to service this requirement. Although we do not believe that the reporting of Transfers throughout the year is a necessary safeguard, we would encourage the Commission to consider the reporting of any Transfer on a monthly, or ideally quarterly, basis. Decreasing the cadence of the reporting will reduce the amount of time, resources, and inefficiencies that accompany this control.

The Commission should consider adding additional time before the Accountant must notify the SEC that it has identified a material discrepancy. Ideally, the Accountant would first notify the Adviser that they identified a material discrepancy before notifying the SEC, which would allow for a period of time to explain or cure any discrepancy, other than a discrepancy that cannot be cured (e.g., misappropriation).

C. *If adopted, the Proposed Rule should incorporate both crypto assets and physical assets into the Self-Custodial Exception.*

While we do not believe that the privately offered securities exception in the existing Custody Rule should be amended, if the Proposed Rule is adopted, we believe it should expand the Self-Custodial Exception to both physical assets and crypto assets.[72] We understand and acknowledge the Commission's concerns regarding crypto asset markets and past failures of crypto asset trading platforms; however, the Proposed Rule would serve to diminish the protections afforded to investors, rather than making them more robust.

We respectfully request that the Commission extend the comment period to discuss the applicability of exceptions to crypto assets alongside physical assets. Furthermore, we encourage

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[71] The Proposed Rule notes how the Accountant's involvement in verifying the Transfer would build "a record for the accountant to review in connection with an annual surprise examination or financial statement audit." Proposed Rule at page 309. This raises questions regarding whether or not the Accountant's involvement in the Adviser's daily controls destroys the accountant's independence thereby preventing the same accountant from undertaking the annual audit. *See* Deloitte Letter.

[72] The Proposed Rule expands for the first time the application of the Custody Rule to assets that are not securities or funds of a Client. In doing so, it is addressing physical assets and crypto assets for the first time. The Commission has not sufficiently justified why it treats physical assets and crypto assets differently with respect to the availability of the Self-Custodial Exception.

We concur with the a16z Letter, which argues that all Client assets that cannot be reasonably custodied with a Qualified Custodian should be eligible for the Self-Custodial Exception. The a16z Letter notes that the Proposed Rule lacks an adequate analysis of why only physical assets should be eligible for the Self-Custodial Exception.

the Commission to consider how crypto asset securities[73] might be eligible for an exception, given the restrictions on Qualified Custodian custody of crypto asset securities and the need for additional guidance on how broker dealers may custody crypto asset securities.[74]

D. *In the event the Proposed Rule is adopted, we respectfully request that the Commission extend the Transition Period and Compliance Date.*

If adopted as proposed, large investment advisers (with over US$1 billion in RAUM) will have only one year from the effective date and smaller investment advisers (with up to US$1 billion in RAUM) will have 18 months from the effective date to comply. This is an incredibly short transition period, especially in light of the numerous unanswered questions regarding the recently adopted and proposed rules that are likely to create significant operational and compliance challenges for investment advisers as well as for the key gatekeepers implicated by the proposal.[75] We request, at a minimum, a 30-month compliance period to permit market participants to adjust to this particularly complex and market defining rule.

X. *Conclusion.*

We respectfully request that the Commission reopen the comment period to allow industry participants the opportunity to digest the complex Proposed Rule, consult with experts and craft informed responses and feedback. These responses and feedback are essential to the Commissions reconsideration and, if warranted, resubmission of a new Proposed Rule. The above referenced issues are the core concerns we have in reading the Proposed Rule; however, they are not the only issues we identified. In the event that the comment period is extended, we expect to provide further comment. We thank you again for the opportunity to comment, and in advance for your consideration of our comments. We would be happy to continue the conversation with the Commission on these important issues.

Sincerely,

/s/ Gregory E. Xethalis
General Counsel &
Chief Compliance Officer

/s/ Daniel A. Leonardo
Deputy General Counsel &
Compliance Officer

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[73] We further note that the Commission regards all crypto asset securities as being created equal, when that could not be further from the truth. Distributed ledger technology is malleable and tokens may be launched in a number of forms. Some crypto assets mimic equity or debt securities, while others are more akin to software licenses or commodities. The Commission has advanced theories that virtually all crypto assets are securities, largely on the premise that the tokens created in connection with an investment contract continue to be the embodiment of that investment contract. Although we disagree with this position, this comment letter is not the appropriate forum for that discussion. *See* Article III of Lummis-Gillibrand; *see also* Lewis Rinaudo Cohen, Gregory Strong, Freeman Lewin and Sarah Chen, "The Ineluctable Modality Of Securities Law: Why Fungible Crypto Assets Are Not Securities," November 10, 2022, available at https://dlxlaw.com/wp-content/uploads/2022/11/The-Ineluctable-Modality-of-Securities-Law-DLx-Law-Discussion-Draft-Nov.-10-2022.pdf.

[74] *See* footnote 12, *supra*.

[75] *See* footnote 14, *supra*.