VIA ELECTRONIC SUBMISSION May 8, 2023

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549

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

Dear Ms. Countryman:

We respectfully submit this letter on behalf of the Wall Street Blockchain Alliance ("WSBA"), in response to the Securities and Exchange Commission's ("SEC") request for comment in connection with the proposed amendments and redesignation of Rule 206(4)-2 (the "current custody rule") under the 1940 Investment Advisers Act, as amended, *Safeguarding Advisory Client Assets*, No. S7-04-23 ("Proposal"). This letter reflects the collective views of our member-based organization.

The WSBA is an industry-leading non-profit trade association based in New York City, with a mission to guide and promote the comprehensive adoption of blockchain technology and digital assets across global markets in a manner that complies with all applicable laws and regulations. The WSBA is structured into Working Groups that, in turn, coordinate the collaboration of leaders across industries and professions to fulfill the WSBA's mission. The WSBA membership encompasses a wide variety of organizations and roles, including, banks, broker-dealers, investment firms, law firms, accounting firms and compliance professionals, all of whom are deeply familiar with and appreciative of laws and regulations relating to blockchain technologies and digital assets.

The WSBA recognizes the importance of implementing appropriate safeguards to protect client assets held by investment advisers. Yet, in seeking to achieve this objective, the Proposal paints with too broad a brush, imposing impractical and prohibitively burdensome restrictions on how digital assets are custodied. There is a substantial danger that adopting the Proposal in its current form would stifle or threaten to extinguish the developing digital asset economy in the United States.

The WSBA urges the SEC not to adopt the Proposal in its current form and to extend the current comment period. Like the digital assets market itself, the Proposal is complex, and its impact on,

and interplay with, existing regulations and pending rulemaking warrants additional consideration. With additional time to review and discuss the Proposal, it is conceivable that potential modifications may be identified that could meaningfully reduce the Proposal's current negative collateral consequences, without compromising its stated goals. Accordingly, the WSBA respectfully requests that the SEC extend the current comment period to provide an adequate opportunity for additional analysis and public input on the Proposal, so that all interested stakeholders – across industries and asset classes – may continue to consider, assess, and provide to the SEC substantive feedback.

The Proposal consists of 432 pages of dense content and hundreds of discrete requests for public comment on a variety of complex and technical subjects. Given the breadth and complexity of the changes that the Proposal would implement, together with the pace in recent months of the SEC's parallel rulemaking, additional time is needed for interested stakeholders to perform the level of analysis required to provide meaningful feedback on the Proposal. The Proposal's changes are perhaps best described as "sweeping." Among other things, in its current form, the Proposal would dramatically expand the current custody rule by (among other things) expanding the scope to include all digital assets held by investment advisers, effectively barring advisers from using most digital asset trading platforms to trade digital assets for clients. The Proposal also introduces unduly burdensome requirements and creates obstacles that would substantially reduce the number of qualified custodians that may provide safeguarding services to fulfill their obligations under the Proposal. Understanding the full impact of these changes, including the potential effects on current business models and existing firm operations, not to mention the costs of additional reporting and compliance under the proposed changes, requires a significantly greater depth of analysis than can be achieved within the current response period.

Yet, even without the more complete analysis that would be possible with an appropriate extension of the comment period, it is apparent that the Proposal should not be adopted by the SEC in its current form for at least the following reasons:

First, the Proposal would greatly expand the reach of the custody requirements to all digital assets, while diminishing the number of qualified custodians that can hold such assets for customers. While the Proposal purports to allow banks and other similar financial institutions to act as qualified custodians, there are merely a handful of banks and other qualified custodians currently providing safeguarding services for digital assets in the United States. Moreover, recent regulatory developments in the United States, including SEC Staff Accounting Bulletin No. 121's guidance raising the balance sheet costs of custodying digital assets for clients, the recent joint statement[1] by federal banking regulators raising "safety and soundness concerns" with respect to digital asset

[1] https://www.fdic.gov/news/financial-institution-letters/2023/fil23001.html

related activities by banks, and the Office of the Comptroller of the Currency (OCC) requirement[2] that banks obtain from their supervisors a non-objection letter prior to engaging in certain digital asset activities, have deterred such institutions from offering custody services for digital assets. As a result, even if an investment adviser was permitted to custody digital assets at a bank under the Proposal, it is unclear whether a sufficient number of banks would be able and willing to provide and/or continue to provide such services. As SEC Commissioner Hester Pierce has explained, this "could leave investors in digital assets *more* vulnerable to theft or fraud, not less" as investors would be left with increasingly fewer options for custodying their assets and potentially increase the industry's exposure to bad actors and risk of loss due to the concentration of qualified custodians.[3]

Second, in what the Proposal concedes "would be a substantial departure from current industry practice,"[4] the Proposal would require investment advisers to enter into a written agreement[5] with, and receive reasonable assurances in writing[6] from, a qualified custodian. These written agreement and reasonable assurances requirements will significantly increase costs for service providers and, ultimately, clients, who will face greater expenses and fewer choices in service providers, many of which will determine it is commercially unviable to continue offering their services with respect to digital assets.

The Proposal would greatly increase operational costs by requiring custodians to reconstruct existing systems and processes to meet new strict liability standards and likewise require custodians to devote significant time and resources to search for insurance coverage or other

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[2] https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-121.html

[3] *See* Hester M. Pierce, *Statement on Safeguarding Advisory Client Assets Proposal* (Feb. 16, 2023) (emphasis in original) available at https://www.sec.gov/news/statement/peirce-statement-custody-021523, citing Proposing Release at 77.

[4] *See id.* at 77.

[5] The Proposal would require the agreement to specify the adviser's agreed-upon level of authority to effect transactions in the client's account and to include covenants requiring the qualified custodian to provide records relating to the client's assets to certain third parties, deliver account statements to clients, and provide a written internal control report to the adviser.

[6] According to the reasonable assurances requirement, an investment adviser must obtain reasonable assurances from—and maintain an ongoing reasonable belief that—a qualified custodian will (i) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss, (ii) indemnify the client (and have insurance arrangements in place) against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct, (iii) not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements, (iv) clearly identify and segregate client assets from the custodian's assets and liabilities, and (v) not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

solutions to mitigate losses arising from the increased financial burden that the implementation of this standard would impose. As noted by the Proposal, qualified custodians and investment advisers would also bear, and likely be forced to pass on to customers, increased expenses associated with negotiating bespoke written agreements and periodically engaging with each other to ensure that the custodian is adhering to written assurances, including costs attributable to attorneys, accountants, and other compliance professionals.

The Proposal also requires a qualified custodian to obtain an internal control report that requires the opinion of an independent public accountant regarding the adequacy of the qualified custodian's controls, a burdensome additional expense that would cost hundreds of thousands of dollars for each internal control report, that may be of dubious added value, particularly because an investment adviser's fiduciary duties already require them to provide oversight of qualified custodians. Assuming there are public accounting firms both familiar with digital assets and willing to undertake this task in the first place, the added cost of these annual examinations is likely to negatively impact customers, as the increased costs likely ultimately would be borne by customers.

Custody services, generally, is a low-margin business, and the few entities that would likely be considered "qualified custodians" may be unwilling or unable to absorb the costs, including the investments of money, time and additional resources required to comply with the Proposal, as well as the developing of new forms, engaging in individual negotiations with many investment advisers, operationalizing the various required provisions, and litigating any resulting disputes. As recognized by the Proposal, these costs could prove prohibitive and force qualified custodians to exit the custodial services market, leading to market contraction, reduced competition, and limited customer choice.

Third, the Proposal will impose other significant hurdles that could be impossible for digital asset custodians to overcome. Given that the market for digital asset insurance is in the very early stages of development (particularly for digital assets issued by decentralized finance protocols), it may not be possible for a qualified custodian to obtain an insurance policy that satisfies the Proposal's requirements or obtain a policy that is not prohibitively expensive. The costs and other burdens described above, in conjunction with the already-low profit margins in the custody services industry, may leave custodians unwilling or unable to satisfy the obligations needed to serve as a qualified custodian under the Proposal, and may disincentivize new custodians from entering into the space.

To the extent the Proposal leaves no qualified custodians willing or able to satisfy its requirements, investment advisers may be forced to cease managing digital assets on behalf of clients. As a result, it would deprive digital asset holders of the services of reputable advisers and leave them more

vulnerable to bad actors, which undermines the intent of the Proposal and the overarching purposes of the SEC's regulatory charter, which is to protect investors and facilitate capital formation.

For all of these reasons, the WSBA respectfully submits that that the SEC should not adopt the Proposal in its current form and, instead, should extend the comment period for additional public feedback on the Proposal.

Thank you for your consideration and for the opportunity to submit this response to the Proposal.

Respectfully Submitted,

THE WALL STREET BLOCKCHAIN ALLIANCE

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