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Submitted via e-mail (rule-comments@sec.gov) May 8, 2023

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

Dear Ms. Countryman,

We appreciate the opportunity to comment on SEC Release No. IA-6240, titled "Safeguarding Advisory Client Assets."[1] In the Proposing Release, the U.S. Securities and Exchange Commission (the "**SEC**" or the "**Commission**") requests comments on its proposed amendments to Rule 206(4)-2[2] under the Investment Advisers Act of 1940,[3] which will be renumbered and redesignated as new rule 223-1 under the Advisers Act (the "**Proposed Safeguarding Rule**").[4] Our comments in this letter (this "**Letter**") focus primarily on the impact that the Proposed Safeguarding Rule may have with respect to digital asset[5] custodial and advisory services.

We greatly appreciate the Commission's willingness to engage in rule making with a goal of reducing or eliminating ambiguity and clarifying market participants' respective obligations.[6] In our view, the development by the Commission of clear, forward-looking rules is critical for the burgeoning digital asset industry to develop in a compliant manner, and to thrive.[7]

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[1] Safeguarding Advisory Client Assets, SEC Release No. IA-6240, 88 FR 14672 (proposed February 15, 2023), *available at* https://www.sec.gov/rules/proposed/2023/ia-6240.pdf (the "**Proposing Release**").

[2] 17 C.F.R. § 275.206(4)-2 (hereinafter referred to as the "**Custody Rule**").

[3] 15 U.S.C. § 80b-1 *et seq*. (hereinafter referred to as the "**Advisers Act**").

[4] In certain cases, we ask for clarity regarding the Proposed Safeguarding Rule. In this context, the term "Proposed Safeguarding Rule" should be interpreted to include the final rule adopting, as modified, the Proposed Safeguarding Rule, the final form of Rule 223-1 and/or any other SEC guidance with respect to the Proposed Safeguarding Rule.

[5] For purposes of this Letter, the term "digital asset" has the meaning given to it in the Proposed Safeguarding Rule (i.e., an asset that is issued and/or transferred using distributed ledger or blockchain technology). Proposing Release at 14676 n. 25.

[6] We acknowledge and appreciate that, by making the Proposed Safeguarding Rule applicable to all customer assets, and not merely those that constitute "customer securities" or "customer funds," in some sense, the Commission has provided the sort of "clarity" for which the digital asset industry has been asking. Indeed, it eliminates the need for lawyers to exercise their discretion when determining whether an asset constitutes funds or a security under U.S. federal securities laws, which necessarily requires a facts-and-circumstances based assessment. We also appreciate that the Commission expressly addressed in its proposing release the application to digital assets of the Proposed Safeguarding Rule.

[7] In particular, we agree that certain modifications to the Custody Rule – and, just as importantly, clarifications concerning which parties may constitute "qualified custodians" – may be necessary in order to reflect developments in the digital asset space, including the emergence of new technologies, such as decentralized finance ("**DeFi**"), and ever-evolving ways in which industry participants may interact and interface in the future.

Nevertheless, as we explain later in this Letter, we are deeply concerned that the proposed expansion of the Custody Rule to the Proposed Safeguarding Rule – and, presumably, the resulting need for more qualified custodians capable of safely custodying significantly greater quantities (whether measured by value, category or sheer number) of customer assets – is being considered at a time when both regulatory and market developments and trends appear to be chilling access by digital asset market participants to the very types of entities that one otherwise might reasonably expect to serve as those qualified custodians, such as banks.

As we will explain below in this Letter, adoption of the Proposed Safeguarding Rule, without modification from the terms described in the Proposing Release, will impose unreasonably significant costs and burdens on a wide variety of market participants, including those who have, to-date, successfully structured their businesses to avoid dealing in customer securities or funds, for example, those digital asset market players who have elected to transact only in bitcoin. While the Commission may have sufficient statutory authority to modify the Custody Rule to apply to all client assets, the Commission's cost estimates are based on current costs, supplies and demand and do not necessarily reflect a potential future state in which qualified custodians, an intentionally limited pool, will be needed to serve a tremendously expanded universe of customer assets.[8]

Given the recent unforeseen failures of certain traditional banks perceived by the market as being crypto-friendly, the bankruptcies of FTX and other previously high-flying digital asset market participants and U.S. federal and state regulators' active enforcement efforts in the crypto space, should the Proposed Safeguarding Rule be adopted, we have serious concerns about the willingness of qualified custodians to custody digital assets – and those that are willing may charge prohibitive fees. Such a shift in supply and demand is likely to result in increased costs to investment advisers, which, in turn, may determine to pass along to their customers such costs or to cease providing investment advisory services with respect to certain asset types deemed too risky.

We believe that the net effect of important gatekeepers exiting the digital assets market will cause customers seeking exposure to digital assets to bear greater risks than they currently do. These risks include investment-related risks, by transacting in digital assets without the assistance of professional advisers knowledgeable in the digital asset market, as well as more practical risks of loss, such as purchasing, selling and self-custodying digital assets without necessarily possessing the required technical expertise or savvy.[9] While we recognize that certain of the impacts of the alleged fraud and misconduct associated with the fall of FTX may have been alleviated, if the relevant digital assets had been held by qualified custodians, it is our concern that, paradoxically, the adoption of the Proposed Safeguarding Rule will result in fewer, not more, digital assets held by qualified custodians.

[8] As will be discussed further in this Letter, the number of entities capable of constituting "qualified custodians" acceptable to the Commission appears to be flat and – given recent rulemaking and regulatory pronouncements -- may even decrease. Requiring the same number of, or fewer, qualified custodians to perform custody services for drastically increasing numbers and types of customer assets is likely to be unduly expensive, and, as a practical matter, it is unclear whether such qualified custodians have the technological capabilities or administrative bandwidth to onboard and provide custodial services for a wide variety of digital and other assets, with little, if any ramp-up period.

[9] We are not suggesting that investment advisers, or the existing Custody Rule as currently applied to digital assets, currently provides "perfect" protection to customers. Investment in digital assets necessarily is fraught with risk. Nevertheless, we note that, perhaps more so than when buying or selling traditional types of securities, such as equity or bonds, persons seeking to gain investment or other exposure to digital assets are in need not just of market knowledge, but also not-insignificant technical abilities, to complete buy, sell, swap and other activities in a 24/7 trading world. As has been discussed for years, in the digital asset space, risk of loss goes far beyond losses related to the economic performance of particular digital assets, entities or teams: risk of loss applies also to the loss, or inadvertent sharing, of a private key, the inputting of an incorrect wallet address, and so on.

In our view, the Commission has not identified a concern or emerging risk so significant as to justify requiring regulatorily compliant businesses that have structured their activities specifically to exclude holding customer securities and funds to restructure their businesses and engage the services of a limited number of qualified custodians,[10] nor to implement onerous changes and introduce impractical agreements that the Commission itself acknowledges "would be a substantial departure from current industry practice."[11] As such, we believe that adoption of the Proposed Safeguarding Rule in its current form would be unreasonably burdensome to such entities and their customers, who may be forced to bear the increased compliance costs in the forms of fees, which arguably are disproportionate to the expected benefit of such changes.[12] In the case of digital assets, adoption of the Proposed Safeguarding Rule may have the practical effect of shifting risks to customers, the parties likely to be least equipped to protect against fraud, theft and other losses,[13] least knowledgeable about digital assets markets and least adept with digital asset purchase and sales mechanics. This ultimately may harm, rather than protect, would-be digital asset investors, including by depriving investors of access to advice from SEC-registered investment advisers.

For all of these reasons, in addition to the sheer number of individual items for which the Commission has sought specific feedback in the over 400 page Proposing Release, we respectfully request that the Commission extend the deadline to provide comments concerning the Proposed Safeguarding Rule. Such an extension will enable the public to better understand the potential costs and market effects of the Proposed Safekeeping Rule's adoption, as well as the outcomes of other pending rulemaking and regulatory enforcement actions, all of which is necessary in order to provide the Commission meaningful feedback.

In the interest of time, however, we respectfully submit to the Commission this Letter, reflecting our preliminary observations. Section I of this Letter provides an overview of the Custody Rule and Proposed Safeguarding Rule. Sections II this Letter highlights certain of our concerns about adoption of the Proposed Safeguarding Rule, specifically with respect to the digital assets market. Section III of this Letter suggests for the

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[10] One digital assets-related example is bitcoin, which has the greatest market capitalization of any digital asset. Key staff from both the Commission and the U.S. Commodity Futures Trading Commission (the "**CFTC**") have confirmed publicly and repeatedly that Bitcoin is a commodity and is not a security. To require those investment advisers who may have structured their businesses conservatively to hold only Bitcoin, in compliance with the stated view of the Commission's current and immediate past Chairs, now to use qualified custodians seems especially counter-intuitive and unduly burdensome, when there is no prohibition on customers purchasing and holding Bitcoin directly.

[11] *See* Proposing Release, supra note 1, 88 FR at 14691.

[12] Similarly, while we acknowledge that certain non-fungible tokens ("**NFTs**") may be securities, in our view some are unlikely to be. The NFT and digital collectibles market is likely to continue to grow – perhaps exponentially – including with the continued development of metaverses, Web 3.0 (described as the next iteration of the internet) and artificial intelligence. The NFT market arguably has the potential to eclipse the traditional art market, without even considering the growing demand to tokenize real-world assets. To require investment advisers to use a qualified custodian to custody all customer NFTs is potentially unworkable – unlike bitcoin, the maximum number of which can ever exist is 21 million, there appears to be no limit to the number of NFTs that may be created.

[13] As Commissioner Hester Peirce aptly observed, "The proposal would expand the reach of the custody requirements to crypto assets while likely shrinking the ranks of qualified crypto custodians. By insisting on an asset neutral approach to custody we could leave investors in crypto assets *more* vulnerable to theft or fraud, not less. We run the risk, in the words of the proposing release, of 'caus[ing] investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss.'[3] We are instructed not to worry, however, because '[t]hese costs would be mitigated . . . to the extent existing qualified custodians develop, or otherwise acquire, innovative safeguarding procedures for crypto assets, or are able to contract with specialized sub-custodians, as a result of the proposed rule.'[4] Other regulatory efforts to dissuade the provision of crypto custody, including Staff Accounting Bulletin 121, would seem to make such developments unlikely." *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.

Commission's consideration a modification to the Proposed Safeguarding Rule may address certain of our concerns, in addition to selected concerns raised by the Commission in the Proposing Release. Section IV of this Letter requests clarification with respect to certain aspects of the Proposed Safeguarding Rule.

I. Background.

A. Custody Rule.

Under the Custody Rule, an SEC-registered investment adviser that has custody[14] of client funds and securities generally must, among other things (1) maintain these client funds or securities with a qualified custodian, (2) have a reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each client of the adviser and (3) have an independent public accountant verify those funds or securities in a surprise examination (subject to certain exceptions, including the "annual audit provision").[15]

While the Custody Rule is approximately three decades old, it has only been updated once to reflect changes in custodial practices. Under the 2003 Amendments,[16] the SEC amended the Custody Rule to expand the types of entities eligible to serve as qualified custodians and make other changes to reflect changes to custodial practices. Currently, certain banks, savings associations, broker-dealers, registered futures commission merchants ("**FCMs**") and foreign financial institutions ("**FFIs**") are eligible to serve as qualified custodians.[17]

B. Proposed Safeguarding Rule.

Although qualified custodians would continue to serve as key gatekeepers under the Proposed Safeguarding Rule, the criteria for satisfying the definition of "qualified custodian" would change for banks, savings associations and foreign financial institutions. The Proposed Safeguarding Rule would also significantly alter the day-to-day operations of qualified custodians. In what we believe to be a substantial departure from current industry practice, the Proposed Safeguarding Rule would require qualified custodians to enter into a

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[14] Under the Custody Rule, "custody" means that the investment adviser, or its related persons, holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them. 17 C.F.R. § 275.206(4)-2(d)(2).

[15] 17 C.F.R. § 275.206(4)-2(a)(4) (surprise examination requirement); 17 C.F.R. § 275.206(4)-2(b)(4) (annual audit provision).

[16] Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2176, 68 FR 56692 (effective Nov. 5, 2003) (the "**2003 Amendments**").

[17] These entities were selected in part because they were the types of financial institutions that customarily provided custodial services and they are subject to extensive regulation and oversight. *See* Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2044, 67 FR 48579, 48582 (proposed July 18, 2002), *available at* https://www.sec.gov/rules/proposed/ia-2044.htm ("**2002 Proposing Release**") ("'Qualified custodians' under the proposed rule would include the types of financial institutions that customarily provide custodial services and are regulated and examined by their regulators with respect to those services."); *see also* 2002 Proposing Release at 48582 n. 30 (noting that "[r]egulatory agencies or self-regulatory organizations require (either by rule or by supervisory policy) these financial institutions to carry fidelity bonds to cover possible losses caused by their employees' fraudulent activities"); *see also* Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2876, 74 FR 25354 (proposed May 20, 2009) *available at* https://www.sec.gov/rules/proposed/2009/ia-2876.pdf ("**2009 Proposed Proposing Release**") at n. 4 (noting that (1) rule 15c3-3 under the Securities Exchange Act of 1934 (the "**Exchange Act**"), requires a broker-dealer to segregate customer funds held by the broker-dealer for the accounts of customers and to take certain steps to protect customer assets, (2) rules 17a-3 and 17a-4 under the Exchange Act require a broker-dealer to create and maintain current, specified books and records to allow the broker-dealer to easily identify what assets belong to each customer and (3) national banks, federal savings associations, and other U.S. banking institutions are subject to extensive regulation and oversight).

written agreement with an adviser[18] and provide reasonable assurances to the adviser with respect to the custody of client assets.[19]

In addition to the changes above, the Proposed Safeguarding Rule would (i) expand the scope of assets that would trigger application of the rule,[20] (ii) require qualified custodians to have "possession or control"[21] of client assets and (iii) modify the Custody Rule's exception for privately offered securities.[22]

II. <u>The Proposed Safeguarding Rule Would Harm Digital Asset Purchasers.</u>

A. <u>The Commission Recognizes that Gatekeepers Provide Important Investor Protection Functions.</u>

Various speeches given by the Commission's current Chair[23] and his immediate predecessor,[24] as well as certain other Commissioners,[25] have emphasized the critical roles that so-called "gatekeepers" (such as qualified custodians, broker-dealers, accountants and securities lawyers) play with respect to mitigating risk in the digital asset space.

In addition to setting forth requirements and standards for such gatekeepers, the Commission periodically issues reminders – to both gatekeepers and the general public – of both the risks inherent in the crypto space

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[18] *Id.* (requiring the written agreement to contain a provision (1) requiring the qualified custodian to provide promptly, upon request, records relating to clients' assets held in the account at the qualified custodian to the SEC or to an independent public accountant engaged for certain purposes, (2) requiring the qualified custodian to send quarterly account statements, (3) requiring the qualified custodian to obtain and provide the adviser with a written internal control report that includes the opinion of an independent public accountant as to certain topics and (4) specifying the adviser's agreed-upon level of authority).

[19] *See* Section (a)(1)(ii) of the Proposed Safeguarding Rule.

[20] While the Custody Rule generally requires an investment adviser with custody of a client's funds or securities to maintain them with a qualified custodian, the Proposed Safeguarding Rule would generally require the investment adviser to maintain all assets with a qualified custodian.

[21] *See* Section (a)(1)(i) of the Proposed Safeguarding Rule. "Possession or control," as defined in Section (d)(8) of the Proposed Safeguarding Rule, means holding assets such that (i) the qualified custodian is required to participate in any change in beneficial ownership of those assets, (ii) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership and (iii) the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

[22] The Proposed Safeguarding Rule modifies the Custody Rule's privately offered securities exception by expanding the exception to include certain physical assets and requiring certain conditions be satisfied in order to rely on the exception. *See* Section (b)(2) of the Proposed Safeguarding Rule (allowing an adviser to rely on this exception only if (i) the adviser reasonably determines that ownership cannot be recorded and maintained by a qualified custodian, (ii) the adviser reasonably safeguards the assets, (iii) the adviser notifies the independent public accountant performing the verification of such asset transfer within one business day, (iv) the independent public accountant verifies asset transfers and notifies the SEC upon the findings of any material discrepancies, and (v) the existence and ownership of the assets are verified during an annual independent verification or as a part of a financial statement audit by an independent public accountant).

[23] *See* SEC Chair Gary Gensler, "This Law and Its Effective Administration": Remarks Before the Practising Law Institute's 54th Annual Institute on Securities Regulation (November 2, 2022) *available at* https://www.sec.gov/news/speech/gensler-remarks-practising-law-institute-110222; *See* SEC Chair Gary Gensler, "Good Counsellors": Remarks Before the Investment Adviser/Investment Company National Seminar: Compliance Outreach Program (November 15, 2022) *available at* https://www.sec.gov/news/speech/gensler-ia-ic-national-seminar-20221115.

[24] *See* SEC Chairman Jay Clayton, Opening Remarks at the Securities Regulation Institute (January 22, 2018) *available at* https://www.sec.gov/news/speech/speech-clayton-012218; *See* Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings (December 11, 2017) *available at* https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

[25] *See* SEC Commissioner Jaime Lizarraga, Digital Assets: Putting Investors First (November 16, 2022) *available at* https://www.sec.gov/news/speech/lizarraga-brooklyn-law-school-20221116; *See* SEC, Testimony on "Oversight of the SEC's Division of Enforcement" Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets (July 21, 2022) *available at* https://www.sec.gov/news/statement/grewal-statement-house-testimony-071922.

and expertise of professional advisers. For instance, on March 23, 2023, the SEC's Office of Investor Education and Advocacy published "Exercise Caution with Crypto Asset Securities: Investor Alert,"[26] in which it stated explicitly, "[….] registration with the SEC by an entity as a "broker-dealer" and/or "investment adviser" provides important protections for investors."[27] The alert also emphasized potential risks and the importance of having an investment plan, noting, "Having an investing plan, as well as understanding your risk tolerance and time horizon, can be critical to your investing success." Similarly, in April 2023, the Commission reminded investment advisers of the importance of understanding the risks of digital assets, in addition to individual clients' risk appetites and abilities to withstand losses, before recommending crypto investments.[28]

Indeed, in November 2022, in "'Good Counsellors': Remarks Before the Investment Adviser/Investment Company National Seminar: Compliance Outreach Program,"[29] the Commission's Chair stated, "[w]hen someone manages another person's money, there will be conflicts and differing incentives. When those incentives and conflicts are managed well—through laws, rules, regulations, and gatekeepers acting as "good counsellors"—that helps to protect investors. As gatekeepers, you help to build and maintain what financial systems need to function: trust. You're the first line of defense—not just, crucially, for investors, but also for your colleagues, who are working to meet various revenue goals for your firms and clients. In following the law, protecting the reputational capital of your firms, and delivering for investors, you help to maintain trust in our system."

The Commission repeatedly has recognized, and emphasized, the investor protection role played by investment advisers and qualified custodians, particularly in the digital asset space.[30] While customers may purchase and hold digital assets directly, without the assistance of a professional adviser, the Commission's guidance appears to support a preference for the involvement of gatekeepers. In the event that the adoption of the Proposed Safeguarding Rule may cause investment advisers and qualified custodians to cease digital

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[26] *See* SEC, Exercise Caution with Crypto Asset Securities: Investor Alert (March 23, 2023) *available at* https://www.sec.gov/oiea/investor-alerts-and-bulletins/exercise-caution-crypto-asset-securities-investor-alert.

[27] Among other things, the alert also explained, "SEC-registered investment advisers that hold or have the ability to obtain possession of their clients' funds or securities are required to maintain those assets with a qualified custodian, like a bank or broker-dealer. SEC-registered investment advisers that have "custody" of client funds and securities are also generally required to undergo an annual "surprise examination" in which an independent public accountant verifies the existence of these assets and to make and keep records showing all purchases and sales for each client. Also, unlike SEC-registered entities, crypto asset securities trading platforms or other intermediaries (such as so-called "crypto exchanges") may offer a combination of services that are typically performed by separate firms that may each be required to be separately registered with the SEC, a state regulator, or a SRO. The commingling of these functions, exchange, broker-dealer and custodial functions, for example, creates conflicts of interest and risks for investors. SEC-registered entities are subject to a number of rules to minimize these risks and conflicts of interests, in some cases by separating the functions into legally separate and unaffiliated entities. Registered broker-dealers, ATSs, and investment advisers are also subject to examination by regulators. None of the major crypto asset entities is registered with the SEC as a broker-dealer, exchange, or investment adviser—so investors may not get the protections afforded by the rules applicable to these entities."

[28] *See* SEC, Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations (April 20, 2023) *available at* https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers#_ftn1.

[29] *See* SEC Chair Gary Gensler, "'Good Counsellors': Remarks Before the Investment Adviser/Investment Company National Seminar: Compliance Outreach Program" (Nov. 15, 2022) *available at* https://www.sec.gov/news/speech/gensler-ia-ic-national-seminar-20221115.

[30] In February 2023, the Commission's Division of Examinations announced its 2023 priorities, among them a description titled "Emerging Technologies and Crypto-Assets," which promised examinations of broker-dealers and registered investment advisors that would "focus on the offer, sale, recommendation of, or advice regarding trading in crypto or crypto-related assets and include whether the firm (1) met and followed their respective standards of care when making recommendations, referrals, or providing investment advice; and (2) routinely reviewed, updated, and enhanced their compliance, disclosure, and risk management practices." *See* SEC, 2023 Examinations Priorities, 14 (announced February 7, 2023) *available at* https://www.sec.gov/news/press-release/2023-24.

asset-related activities, this would seem to increase risks to customers seeking exposure to digital assets.[31] In a statement given in connection with the Proposing Release, Commissioner Hester Peirce appeared to share that concern, stating, "By insisting on an asset neutral approach to custody we could leave investors in crypto assets *more* vulnerable to theft or fraud, not less. We run the risk, in the words of the proposing release, of 'caus[ing] investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss.'"[32]

B. Few Qualified Custodians Currently Exist in the Digital Assets Market.

By taking an asset-neutral approach, the Proposed Safeguarding Rule would greatly expand the universe of assets required to be maintained by "qualified custodians," yet impediments exist to growing the number of "qualified custodians" for digital assets. In fact, adoption of the Proposed Safeguarding Rule could cause the number of qualified custodians to shrink.[33]

1. The Digital Asset Custodial Market Is Thin, and Market Dynamics Deter New Providers from Entering the Market.

The market for digital asset custodial services—similar to the market for custodial services for privately offered securities—is fairly thin.[34] As the Commission explains in the Proposing Release, the digital asset custody market comprises only "one OCC-regulated national bank, four OCC-regulated trusts, approximately 20 state-chartered trust companies and other state-chartered, limited purpose banking entities, and at least one FCM."[35] In some cases, such as custodial services for digital assets issued by certain DeFi protocols, we understand that there are no qualified custodians willing to provide custodial services.[36] While the custodial service industry is characterized by high barriers to entry and low margins,[37] new entrants seeking to penetrate the digital asset custodial services market face significant additional burdens, including the time and cost involved in analyzing and mitigating the risks of the blockchains and smart contracts associated with the digital assets to be custodied, not to mention significant costs, as discussed more fully below.

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[31] Notably, the July 2019 SEC and FINRA joint statement concerning digital asset custody emphasized how digital asset securities, as opposed to traditional securities, are particularly susceptible to being lost due to cyber fraud, cyber theft, or the loss of a private key. Custody of Digital Asset Securities by Special Purpose Broker-Dealers, SEC Release No. 34-90788, 86 FR 11627, 11629 (published Feb. 26, 2021) *available at* https://www.sec.gov/rules/policy/2020/34-90788.pdf.

[32] *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, supra note 1, 88 FR at 14691.

[33] *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.

[34] *See* Proposing Release, supra note 1, 88 FR at 14739 (noting that the market for crypto asset custodial services continues to develop).

[35] *Id.*

[36] Given the role played by smart contracts in certain DeFi protocol tokens and the diligence involved in assessing smart contract risk, this is not surprising. For example, smart contracts are subject to rug pulls. *See* Financial Stability Oversight Council, Report on Digital Asset Financial Stability Risks and Regulation (2022), *available at* https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf ("rug pulls may also involve the coding of an explicit, malicious backdoor into a new crypto-asset smart contract, which allows the developer to pull out all of the liquidity of the crypto-asset at once") (citing Valerio Puggini, "Crypto rug pulls: what is a rug pull in crypto and 6 ways to spot it," Coin Telegraph, February 6, 2022, at https://cointelegraph.com/explained/crypto-rug-pulls-what-is-a-rug-pull-in-crypto-and-6-ways-to-spot-it and Koinly, "Rug Pulls: Your Complete Guide," March 31, 202, *available at* https://koinly.io/blog/crypto-rug-pulls-guide/.)

[37] *See* Proposing Release, supra note 1, 88 FR at 14737 (noting economies of scale and low margins as factors contributing to the dominance of the custody service industry by a small number of participants)

C. Uncertainty Exists Concerning Which Digital Asset Custodians May Constitute "Qualified Custodians" in the Commission's View.

The current limited number of digital asset custodians is further complicated by the question of which such custodians would constitute "qualified custodians" in the Commission's view. In fact, the Commission's current Chair, Gary Gensler, reportedly recently asserted, "Based upon how crypto trading and lending platforms generally operate, investment advisers cannot rely on them today as qualified custodians. To be clear: Just because a crypto trading platform claims to be a qualified custodian doesn't mean that it is."[38] Yet, as explained below, even for the types of entities that typically serve as qualified custodians in non-digital assets contexts, uncertainty exists concerning whether such entities can serve as qualified custodians for digital assets.

1. No Special Purpose Broker-Dealers Exist.

While broker-dealers might otherwise appear well-positioned to provide digital asset custodial services, the Proposing Release indicates that, currently, no registered broker-dealers serve as qualified custodians for digital asset securities. One reason for that may be traced to the Commission's April 2021 statement regarding the Customer Protection Rule ("**CPR Statement**").[39] In 2019, the Commission and the Financial Industry Regulatory Authority had published a "Joint Staff Statement on Broker-Dealer Custody of Digital Assets," expressing concerns with digital asset custody.[40] The CPR Statement was designed to encourage innovation around the application of the Customer Protection Rule to digital asset securities.[41]

While the CPR Statement provided guidance for registered broker-dealers seeking to custody digital asset securities without running afoul of the Customer Protection Rule, it imposed new hurdles for those interested in entering the space. For example, existing registered broker-dealers wishing to provide digital asset custody services under the guidance set forth in the CPR Statement would have to establish a new, special purpose

[38] During a recent Investor Advisory Committee meeting, Commission Chair Gensler reportedly also "pointed to recent bankruptcies in the crypto sector, noting that customers' property held on those platforms are now part of the bankruptcy estate, rather than returning directly to the customers." *See* Nikhilesh De, SEC Chair Gensler Says Crypto Exchanges May Not Be 'Qualified Custodians', CoinDesk (Mar. 2, 2023) *available at* https://www.coindesk.com/policy/2023/03/02/sec-chair-gensler-says-crypto-exchanges-may-not-be-qualified-custodians/.

[39] Custody of Digital Asset Securities by Special Purpose Broker-Dealers, Exchange Act Release No. 34-90788, 86 FR 11627 (effective April 27, 2021), *available at* https://www.govinfo.gov/content/pkg/FR-2021-02-26/pdf/2020-28847.pdf. Rule 15c3-3 promulgated under the Securities Exchange Act of 1934 (hereinafter the "**Customer Protection Rule**").

[40] See SEC, 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 (emphasizing how digital asset securities, as opposed to traditional securities, are particularly susceptible to being lost due to cyber fraud, cyber theft, or the loss of a private key. The Commission stated that the traditional infrastructure "contains checks and controls that can be used to verify proprietary and customer holdings of traditional securities by broker-dealers, as well as processes designed to ensure that both parties to a transfer of traditional securities agree to the terms of the transfer.") Custody of Digital Asset Securities by Special Purpose Broker-Dealers, SEC Release No. 34-90788, 86 FR 11627, 11629 (published Feb. 26, 2021) available at https://www.sec.gov/rules/policy/2020/34-90788.pdf.

[41] Custody of Digital Asset Securities by Special Purpose Broker-Dealers, *supra* note 20, 86 FR at 11627.

broker-dealer.[42] Although it has been approximately two years since the effective date of the CPR Statement, no special purpose broker-dealer has yet been approved.

2. It Is Unclear Whether State-Chartered Trust Companies Constitute "Qualified Custodians" for Purposes of the Commission's Existing Custody Rule.

Insufficient guidance exists concerning whether state-chartered trust companies constitute "qualified custodians" for the purposes of the Commission's existing Custody Rule. Under the Custody Rule, state-chartered trust companies under certain circumstances may be treated as a "bank," and, therefore, as a "qualified custodian." Yet, it is not necessarily clear which state-chartered trust companies may be "qualified custodians," including for digital assets.

In October 2020, the Wyoming Division of Banking issued a no-action letter to Two Ocean Trust (the "**Two Ocean No-Action Letter**"), in which it also confirmed that Two Ocean could serve as a "qualified custodian" for digital assets under the Custody Rule, based on the definition of "bank" under the Advisers Act. Yet, approximately two weeks later, in November 2020, the Commission's Division of Investment Management staff, in consultation with FinHub, responded by publishing a "Staff Statement on WY Division of Banking's 'NAL on Custody of Digital Assets and Qualified Custodian Status'"[43] (the "**Commission's Two Ocean Response**"). The Commission's Two Ocean Response explained that the Two Ocean No-Action Letter sought to provide interpretative guidance on a critical component of the Custody Rule, the definition of "qualified custodian," which, the Commission emphasized, is the purview of the Commission and not the State of Wyoming.

The Commission's Two Ocean Response explained further that the determination of what constitutes a qualified custodian is "a complicated, and facts and circumstances based, analysis given the critical role qualified custodians play within this framework by safeguarding the client assets entrusted to investment advisers." In addition, the Commission's Two Ocean Response "encourage[d] interested parties to engage directly with the Commission staff on the application of the Custody Rule to digital assets, including with respect to the definition of "qualified custodian" under the rule," reminded registered investment advisers of their regulatory obligations under the Custody Rule, and solicited feedback on "issues related to the development of staff recommendations to amend the Custody Rule."

While in its current form, the Proposed Safeguarding Rule would not modify the ability of state-chartered trust companies to serve as qualified custodians, the Commission has raised various questions regarding the quality of regulatory protections and oversight imposed on such companies. As such, while a state-chartered trust company may be treated as a "bank," and therefore a "qualified custodian" under the Proposed Safeguarding Rule, no clear guidance from the Commission exists concerning under which circumstances state-chartered trusts may be treated as "qualified custodians" for digital assets.

[42] Custody of Digital Asset Securities by Special Purpose Broker-Dealers, *supra* note 20, 86 FR at 11631 (noting that, for a period of five years, the SEC's position is that a broker dealer that (among other things) generally "limits its business to dealing in, effecting transactions in, maintaining custody of, and/or operating an alternative trading system for digital asset securities" would not be subject to an SEC enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities for purposes of paragraph (b)(1) of the Customer Protection Rule).

[43] *See* SEC, Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020) *available at* https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

3. Regulatory Hurdles Limit the Ability of Banks to Engage in Digital Asset-Related Activities.

Under the Custody Rule, banks may constitute "qualified custodians." Yet while banks might appear to be logical beneficiaries of the Proposed Safeguarding Rule's increased demand for "qualified custodians," recent regulatory pronouncements, rulemaking and market sentiments appear to signal a trend towards limiting banks' engagement in digital asset-related activiites. This suggests that the universe of entities capable of constituting "qualified custodians" for digital assets actually may shrink.

a) OCC Pronouncements Require Prior Approval of Crypto-Related Activities.

In the past couple of years, the OCC's position with respect to the digital assets industry appears to have shifted,[44] from encouraging banks to embrace new technologies and related activities, such as crypto custody, to discouraging banks from engaging in digital asset-related activities, cautioning them against compromising sound risk management in search of increased yield. We believe that this changed regulatory stance negatively affects banks' abilities and appetites to perform crypto custody services.

In July 2020, the OCC published a letter clarifying that federally chartered banks and thrifts may provide custody services for crypto assets (the "**OCC Crypto Custody Letter**").[45]

Yet more recently, the OCC's pronouncements have emphasized the need for greater caution with respect to banks' risk management and engagement with digital assets activities. In May 2021, current Acting Comptroller Michael Hsu expressed concern that ""banks of all sizes may be tempted to reach for yield, operate beyond their risk appetites, or compromise their sound risk management."[46]

In November 2021, the OCC published, "Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank"

[44] For instance, in 2018, the OCC announced that it would begin accepting from Fintech companies applications for special-purpose national bank charters ("**Fintech charters**"), a concept first introduced in 2016. *See* Off. of the Comptroller of the Currency, Policy Statement on Financial Technology Companies' Eligibility to Apply for National Bank Charters (July 31, 2018) *available at* https://www.occ.gov/news-issuances/news-releases/2018/pub-other-occ-policy-statement-fintech.pdf. More recently, the OCC has appeared to cease granting Fintech charters.

[45] *See* Off. of the Comptroller of the Currency, Federally Chartered Banks and Thrifts May Provide Custody Services For Crypto Assets (July 22, 2020) *available at* https://www.occ.gov/news-issuances/news-releases/2020/nr-occ-2020-98.html. The OCC Crypto Custody Letter explained that "providing cryptocurrency custody services, including holding unique cryptographic keys associated with cryptocurrency, is a modern form of traditional bank activities related to custody services. Crypto custody services may extend beyond passively holding 'keys,'" and quoted then-current Acting Comptroller Brian Brooks, "From safe-deposit boxes to virtual vaults, we must ensure banks can meet the financial services needs of their customers today. [….] This opinion clarifies that banks can continue satisfying their customers' needs for safeguarding their most valuable assets, which today for tens of millions of Americans includes cryptocurrency."

[46] *See* Statement of Michael J. Hsu Acting Comptroller of the Currency before the Committee on Financial Services United States House of Representatives (May 19, 2021) *available at* https://www.occ.gov/news-issuances/congressional-testimony/2021/ct-occ-2021-56-written.pdf. Separately, he has warned of risks concerning stablecoins, DeFi and other digital assets, including the possibility of triggering another financial crisis. *See* Remarks Before the Institute of International Economic Law at Georgetown University Law Center "Thoughts on the Architecture of Stablecoins", Michael J. Hsu, Acting Comptroller of the Currency (April 8, 2022) *available at* https://www.occ.gov/news-issuances/speeches/2022/pub-speech-2022-37.pdf.

(the "**OCC Clarification Letter**").[47] Importantly, while the OCC Clarification Letter confirmed that banks are permitted to engage in the types of activities described in the existing interpretive letters, including crypto custody, it emphasized that a bank should not engage in such digital asset-related activities until it receives notification of non-objection from its supervisory office.[48] In other words, banks would need advanced permission to provide, among other things, digital asset custody.

This separation by the OCC of banks from digital asset activities has been demonstrated further in the contexts of merger and acquisition approvals.[49]

In January 2023, the OCC, the FDIC and the Federal Reserve (the "**Fed**") issued a Joint Statement on Cryptoasset Risks to Banking, warning, among other things, that certain digital asset-related activities were highly likely to be inconsistent with safe and sound business practices.[50] In February 2023, the OCC, the FDIC and the Fed published another joint statement, cautioning that crypto activities might pose a safety and soundness risk, highlighting liquidity risks to banking organizations associated with certain sources of funding from crypto-asset-related entities and some effective practices to manage those risks.[51]

In March 2023, following the swift and unexpected failures of certain banks perceived to be crypto-friendly, including Signature Bank and Silicon Valley Bank, and the liquidation of Silvergate Capital, many, including some in government, initially blamed the digital assets industry, sparking market fears that crypto would be

[47] The OCC Clarification Letter sought to clarify the following existing interpretive letters, "OCC Interpretive Letter 1170, addressing whether banks may provide cryptocurrency custody services; OCC Interpretive Letter 1172, addressing whether banks may hold dollar deposits serving as reserves backing stablecoin in certain circumstances; and OCC Interpretive Letter 1174, addressing (1) whether banks may act as nodes on an independent node verification network (i.e., distributed ledger) to verify customer payments and (2) banks may engage in certain stablecoin activities to facilitate payment transactions on a distributed ledger." *See* Interpretive Letter 1179, Off. Of the Comptroller of the Currency (November 18, 2021) *available at* https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf.

[48] The OCC Clarification Letter explained that banks must be able to "demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner. As discussed below and consistent with longstanding OCC precedent, a proposed activity cannot be part of the 'business of banking' if the bank lacks the capacity to conduct the activity in a safe and sound manner. Specifically, as described further below, a bank should notify its supervisory office, in writing, of its intention to engage in any of the activities addressed in the interpretive letters. The bank should not engage in the activities until it receives written notification of the supervisory office's non-objection. In deciding whether to grant supervisory non-objection, the supervisory office will evaluate the adequacy of the bank's risk management systems and controls, and risk measurement systems, to enable the bank to engage in the proposed activities in a safe and sound manner."

[49] For instance, in January 2022, when Social Finance Inc. ("**SoFi**") acquired a national bank as a condition to the OCC's approval of that acquisition, and the creation of SoFi Bank, N.A., the resulting entity was required to cease engaging in digital asset activities. *See* Conditional Approval 1277, Off. Of the Comptroller of the Currency (January 18, 2022) available at https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2022/ca1277.pdf. In addition, in October 2022, the OCC "required a national bank to divest crypto-assets held as principal that it acquired through a merger with a state bank. Specifically, the OCC conditioned its recent approval of the merger between Flagstar Bank, FSB and New York Community Bank into Flagstar Bank, NA on the divestiture of holdings of 'Hash,' a crypto-asset, after a conformance period, as well as a commitment not to increase holdings of any crypto-related asset or token 'unless and until the OCC determines that . . . Hash or other crypto-related holdings are permissible for a national bank.'" *See* Policy Statement on Section 9(13) of the Federal Reserve Act, 88 FR 7848 (Feb. 7, 2023) *available at* https://www.federalregister.gov/documents/2023/02/07/2023-02192/policy-statement-on-section-913-of-the-federal-reserve-act, citing OCC Conditional Approval Letter No. 1299, at 9 (October 27, 2022).

[50] Fed. Deposit Ins. Corp., Joint Statement on Crypto-Asset Risks to Banking Organizations (January 3, 2023) *available at* https://www.occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf.

[51] Fed. Deposit Ins. Corp., Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2023) *available at* https://www.fdic.gov/news/press-releases/2023/pr23010a.pdf.

“unbanked.”[52] The OCC conditionally approved[53] Flagstar Bank, N.A. to purchase and assume certain liabilities of Signature Bridge Bank, N.A., yet Signature Bank’s digital asset-related business reportedly was excluded from the purchase.[54] Although regulators subsequently confirmed[55] that poor management and oversight failures, rather than crypto-related activities, caused Signature Bank’s and Silicon Valley Bank’s respective failures, some continue to believe in, or fear, the existence of a supposed governmental “Operation Chokepoint 2.0,” intended to separate digital assets from banks.[56]

b) Federal Reserve Actions Limiting Activities of Member Banks.

Despite denials of a concerted governmental effort to “de-bank” crypto, the Fed arguably also has signaled the need for separation of digital assets from the traditional banking sector.

In addition to the January and February 2023 joint statements referenced above, issued by the Fed with the OCC and the FDIC, in January 2023, the Fed denied Custodia Bank Inc.’s application to be a member of the Federal Reserve System. When explaining the basis for such denial, in part, the Fed explained that,[57] “[t]he firm's novel business model and proposed focus on crypto-assets presented significant safety and soundness risks. The Board has previously made clear that such crypto activities are highly likely to be inconsistent with safe and sound banking practices. The Board also found that Custodia's risk management framework was insufficient to address concerns regarding the heightened risks associated with its proposed crypto activities, including its ability to mitigate money laundering and terrorism financing risks.”

On the same day, the Fed released a policy statement interpreting Section 9(13) of the Federal Reserve Act. Among other things, the statement described a “presumptive prohibition” on most digital asset-related activities undertaken by state members banks, acting as principals,[58] and a presumption that such activities will be inconsistent with safe and sound business practices. Although the policy statement clarifies that digital asset custodial services are not presumptively prohibited, it qualifies such statement by noting, “[n]othing in the policy statement would prohibit a state member bank, or an applicant to become a state member bank,

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[52] Jennifer Calver, Jonathan Ching and Joshua Ashley Klayman, Silvergate, Silicon Valley Bank, Signature and the “Unbanking” of U.S. Crypto (March 17, 2023) *available at* https://www.linklaters.com/en-us/insights/blogs/fintechlinks/2023/march/silvergate-silicon-valley-bank-signature-and-the-unbanking-of-us-crypto.

[53] Office of the Comptroller of the Currency, Application by Flagstar Bank, National Association, Hicksville, New York, to purchase certain assets and assume certain liabilities of Signature Bridge Bank, National Association, New York, New York (March 19, 2023) *available at* https://www.occ.treas.gov/news-issuances/news-releases/2023/nr-occ-2023-27a.pdf.

[54] *See* “Signature Crypto Customers Get One Week to Remove Funds; Signet is Up for Sale.” Forbes (May 29, 2023) *available at* https://www.forbes.com/sites/digital-assets/2023/03/29/signature-crypto-customers-get-one-week-to-remove-funds-signet-is-up-for-sale/?sh=631b80d77b26.

[55] Fed. Deposit Ins. Corp., FDIC’s Supervision of Signature Bank (April 28, 2023) *available at* https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf; Federal Reserve Board, Federal Reserve Board announces the results from the review of the supervision and regulation of Silicon Valley Bank, led by Vice Chair for Supervision Barr (April 28, 2023) *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230428a.htm.

[56] In addition, it was reported that Globally Systemically Important Banks (“**GSIBs**”) may have been prohibited from bidding to acquire Signature Bank. https://twitter.com/davidmarcus/status/1634622108893609984. It is unclear whether any banks permitted to bid had sufficient experience with digital assets such that the bank supervisor would have granted a non-objection letter with respect to purchasing the digital assets businesses. It is equally unclear whether Flagstar Bank, N.A. wanted to acquire any digital asset-related portion of the business.

[57] Fed. Reserve Board, Federal Reserve Board announces denial of application by Custodia Bank, Inc. to become a member of the Federal Reserve System (January 27, 2023) *available at* https://www.federalreserve.gov/newsevents/pressreleases/orders20230127a.htm.

[58] “The Policy Statement governs ‘novel activities’ that both FDIC-insured state member banks and non-insured state institutions (that may be admitted to Federal Reserve membership) may propose. A state member bank must first consult federal statutes, OCC regulations, and OCC interpretations to determine whether national banks are permitted to undertake the activity.” https://www.jdsupra.com/legalnews/federal-reserve-narrows-the-crypto-6358127/.

once approved, from providing safekeeping services for crypto-assets in a custodial capacity if such activities are conducted in a safe and sound manner and in compliance with consumer, anti-money-laundering, and anti-terrorist-financing law."[59] This likely leads back, among other things, to the OCC non-objection requirements described above in this Letter, concerning digital asset custody, as, among other things, state member banks generally must determine whether national banks are permitted to undertake the activity.[60]

In any event, some believe that the Fed's recent pronouncements concerning digital assets serve as a regulatory "dog whistle," encouraging member banks to limit or cease their provision of digital asset-related services.

D. Regulatory Signals May Chill the Appetite of Existing "Qualified Custodians" to Custody Digital Assets.

In January 2023, the National Education Council ("NEC") published "The Administration's Roadmap to Mitigate Cryptocurrencies' Risks,"[61] urging Congress to pass laws concerning digital assets. Yet, notably, the NEC warned, "Legislation should not greenlight mainstream institutions, like pension funds, to dive headlong into cryptocurrency markets. In the past year, traditional financial institutions' limited exposure to cryptocurrencies has prevented turmoil in cryptocurrencies from infecting the broader financial system. It would be a grave mistake to enact legislation that reverses course and deepens the ties between cryptocurrencies and the broader financial system."

In fact, in the current market, even regulatory announcements designed to protect investors may be subject to interpretation that they actually are intended to prevent banks from custodying digital assets. For example, the Commission's April 2022 SEC Staff Accounting Bulletin[62] requiring public companies to make certain disclosures and record on their balance sheets a liability and corresponding asset with respect to digital assets held by them as custodian, has faced "criticism that the guidance is blocking well-regulated banks from providing digital asset custody services and driving investors to offshore providers."[63]

By vastly expanding the types of assets required to be held by a "qualified custodian," without expanding the number or type of institutions that may serve as "qualified custodians," the Commission is likely to significantly

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[59] *See* Policy Statement on Section 9(13) of the Federal Reserve Act, 88 FR 7848 (Feb. 7, 2023) *available at* https://www.federalregister.gov/documents/2023/02/07/2023-02192/policy-statement-on-section-913-of-the-federal-reserve-act.

[60] Interestingly, FN 17 of the Fed's release notes that "To date, the OCC has not made a determination addressing the permissibility of a national bank holding crypto-assets as principal, other than "stablecoins" to facilitate payments subject to the conditions of OCC Interpretive Letter 1179. See OCC Interpretive Letter No. 1174 (January 4, 2021) (Interpretive Letter 1174); OCC Interpretive Letter No. 1179 (November 18, 2021) (Interpretive Letter 1179). The OCC has required a national bank to divest crypto-assets held as principal that it acquired through a merger with a state bank. Specifically, the OCC conditioned its recent approval of the merger between Flagstar Bank, FSB and New York Community Bank into Flagstar Bank, NA on the divestiture of holdings of "Hash," a crypto-asset, after a conformance period, as well as a commitment not to increase holdings of any crypto-related asset or token "unless and until the OCC determines that . . . Hash or other crypto-related holdings are permissible for a national bank." OCC Conditional Approval Letter No. 1299, at 9 (October 27, 2022)."

[61] See National Education Council, "The Administration's Roadmap to Mitigate Cryptocurrencies' Risks" (Jan. 27, 2023) *available at* https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/.

[62] *See* SEC Staff Accounting Bulletin No. 121, 87 FR 21015 (Apr. 11, 2022), *available at* https://www.sec.gov/oca/staff-accounting-bulletin-121 (providing interpretive guidance for reporting entities that engage in activities in which they have an obligation to safeguard customers' crypto assets. SAB 121 requires a reporting entity that performs crypto asset custodial activities, whether directly or through an agent acting on its behalf, to record a liability with a corresponding asset, among other requirements).

[63] *See* "SEC Chair Gensler Defends Staff Accounting Bulletin 121 in Crypto-Heavy House Hearing" Thomson Reuters (April 19, 2023) *available at* https://tax.thomsonreuters.com/news/sec-chair-gensler-defends-staff-accounting-bulletin-121-in-crypto-heavy-house-hearing/.

increase – across the board – demand for the services of existing gatekeepers. Given the significant technical and regulatory barriers to entry described above, the current intense crypto enforcement focuses of federal and state regulators, and other governmental messages warning the market of systemic risk, the types of gatekeepers that have routinely served as "qualified custodians" may have less appetite to provide digital asset custody services. Substantial evidence, such as the above-mentioned statements, bulletins and final rules, supports the proposition that the current U.S. regulatory climate – to which custodial service providers are subject – is unfriendly to crypto, thus deterring qualified custodians from custodying crypto and investment advisers from managing clients' digital assets.

While that may be the goal (i.e., to avoid "greenlight[ing] mainstream institutions, like pension funds, to dive headlong into cryptocurrency markets"), as noted above, removing the availability of important gatekeepers from the digital assets investment process is unlikely to stop crypto investment. Instead, it is more likely to make crypto investing more risky.

E. <u>The Proposed Safeguarding Rule Would Impose Prohibitive Costs On Digital Asset Custodians.</u>

As noted by the Proposing Release, the Proposed Safeguarding Rule would impose costs and other burdens on digital asset custodians. For example, digital asset custodians would incur legal fees and other costs in negotiating and drafting the written agreement to be entered into with an investment adviser. After entering into the written agreement, digital asset custodians would bear the costs of complying with the covenants under the agreement and of periodic interactions with investment advisers, who must monitor the qualified custodians' compliance with certain aspects of the agreement.

Although the Proposing Release notes that qualified custodians also would bear the costs associated with the enhanced scope of the internal control requirement, we are concerned that the Proposing Release's cost calculations may substantially underestimate this burden. The Proposing Release suggests that 95% of qualified custodians currently obtain internal control reports that satisfy the Proposed Safeguarding Rule, while 5% of qualified custodians do not currently obtain an internal control report that would be compliant with the Proposed Safeguarding Rule.[64] However, the Proposing Release suggests that there is a third category of internal control report: one that partially satisfies the requirements of the Proposed Safeguarding Rule. For example, the Proposing Release states that the scope of existing qualified custodian internal control reports likely covers the qualified custodian's safeguarding activities for "funds and securities" rather than all assets.[65] The Proposing Release also notes that certain internal control reports may not satisfy the requirements of the Proposed Safeguarding Rule (e.g., a SOC 1 Type 1 Report, which does not test the operation effectiveness of the controls). To the extent the Proposed Safeguarding Rule considers partially compliant internal control reports as fully compliant internal control reports (i.e., includes partially compliant internal control reports

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[64] The Proposing Release estimates total aggregate monetized costs attributable to the internal control report requirement to be $35,962,500. This figure is the product of (1) 959 (the estimated number of qualified custodians that would need to obtain an internal control report under the Proposed Safeguarding Rule), (2) $750,000 (the average approximate cost of an internal control report) and (3) 5% (the percent of qualified custodians that are not currently obtaining an internal control report). Since the 5% figure represents the percent of qualified custodians that are not currently obtaining an internal control report in compliance with the Proposed Safeguarding Rule, the Proposing Release implies that 95% of qualified custodians are currently obtaining an internal control report that complies with such rule.

[65] Although the Proposing Release notes that increased costs associated with the increased scope of the internal control reports would be mitigated to the extent that newly included assets would share existing controls or implicate controls similar to those for funds and securities, we do not expect any cost mitigation to occur to the extent the control reports capture digital assets when such reports previously were not required to.

within the 95% figure cited earlier), the Proposing Release would underestimate, perhaps substantially, the compliance costs borne by qualified custodians with respect to the internal control report requirement.

It is important to note that, as a result of the interaction between the Proposed Safeguarding Rule and other SEC-proposed rulemaking, the potential cumulative costs of compliance with Advisers Act rules may be significantly higher than anticipated. For example, an adviser subject to the Proposed Safeguarding Rule may need to find a qualified custodian to custody a client's bitcoin (as the adviser may have been content that the Custody Rule did not require the client's bitcoin to be maintained by a qualified custodian). An adviser facing this circumstance also would need to assess compliance with the Outsourcing Rule[66] (including the due diligence, monitoring and recordkeeping obligations that the Outsourcing Rule seeks to impose) and other SEC-proposed rules that my affect the adviser's business. To be sure, these cumulative compliance costs would be borne not only by investment advisers, but also by their clients.

In addition, the Proposed Safeguarding Rule may pose hurdles that are impossible for digital asset custodians to overcome. Given that the market for digital asset insurance is in its early stages of development—particularly for certain digital assets associated with decentralized finance ("**DeFi**") protocols—it may not be possible for a qualified custodian to obtain an insurance policy that satisfies the requirements of the Proposed Safeguarding Rule. To the extent insurance is available, it may be costly, prompting qualified custodians to increase fees to their clients in order to offset any increase in insurance-related expenses.

F. The Proposed Safeguarding Rule Ultimately Will Harm Investors.

Given the fragile market dynamics facing digital asset custodial services providers and our other remarks noted above, we anticipate that the Proposed Safeguarding Rule will result a reduction in the pace of new entrants into the digital asset custody market. To the extent that a robust market for digital asset custodial services fails to develop or, in fact, contracts, investor harm would ensue.[67]

Importantly, investors in digital assets need not hold these assets through an investment advisor. Unlike conventional securities such as stocks and bonds, digital assets may be held relatively easily by investors on a digital platform. Although the Commission has made clear its view that digital asset trading platforms permitting U.S. persons and persons present or located in the U.S. to transact in digital assets constituting securities are subject to SEC registration requirements and supervision, at present, in the U.S there are no national securities exchanges trading digital assets, and the limited number of alternative trading systems do not have the digital asset trading volume of the well-known unregistered platforms. To the extent the price or availability of digital asset custody discourages investors from holding digital assets through SEC-registered investment advisors, investors will lose an important protection in the form of advice from SEC-registered and supervised investment advisors. As noted above, Commission guidance has emphasized the critical role that gatekeepers, including registered investment advisors and qualified custodians, play in investor protection.

[66] Outsourcing by Investment Advisers, Investment Advisers Act Release No. 6176, 87 FR 68816 (proposed October 26, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-6176.pdf (proposing the adoption of rule 206(4)-11 under the Advisers Act (the "**Outsourcing Rule**")).

[67] The Proposing Release notes that client harm would ensue if a robust market for custodial services fails to develop for physical assets and privately offered securities. *See* Proposing Release, *supra* note 1 at 14705-14706 ("Absent such a development and the exception, however, advisers would be faced with the inability to comply with an SEC requirement or a need to transition to providing nondiscretionary advice or take certain other actions in order to avoid a violation of SEC rules, which could be disruptive or result in client harm."). We contend that the same client harm will ensue if there is a similar failure with respect to custodial services for digital assets.

Investor losses in the digital asset space arguably may be amplified if would-be digital asset purchasers are left without professional assistance, to fend for themselves.

To the extent digital asset custodians are unwilling or unable to satisfy the obligations needed to serve as a "qualified custodian" under the Proposed Safeguarding Rule, advisory clients that have engaged such custodians may need to transition to a custodian that complies with the rule. The transition may require the client's investment adviser to spend time and resources vetting the new custodian and would impose other switching costs on the adviser and its clients. In addition, the investment adviser may be forced to choose an alternative digital asset custodian that has weaker private key security and other practices—subjecting client assets to a greater risk of loss and requiring the adviser to increase its monitoring of the custodian. [68]

To the extent the Proposed Safeguarding Rule leaves no qualified custodians that satisfy its requirements, investment advisers subject to the rule may be forced to cease managing crypto assets on behalf of clients. Ironically, such an impact would undermine two key aspects of the SEC's mission: promoting capital formation and investor protection.

III. Proposed Modification to Safeguarding Rule.

A. Exception to Qualified Custodian Requirement for Digital Assets.

While the role that qualified custodians play in safeguarding and protecting the misappropriation of assets is important,[69] we respectfully urge the Commission to consider adopting an exception to the qualified custodian requirement with respect to certain digital assets. Specifically, we propose to exempt investment advisers from the requirement to maintain digital assets with a qualified custodian (to the extent such investment advisers are subject to the Proposed Safeguarding Rule and have custody of a client's digital assets) (the "**Proposed Digital Asset Custodian Exception**") if:

- The adviser reasonably determines and documents in writing ownership of a digital asset cannot be recorded and maintained in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets;
- The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency;
- An independent public accountant, pursuant to a written agreement between the adviser and the accountant, (i) verifies any transfer of beneficial ownership of such assets, promptly upon receiving

[68] While we agree with the Proposing Release that qualified custodians have a "long history of developing different procedures for safeguarding a variety of assets" (such as bank custodians, which the Proposing Release notes have traditionally provided safekeeping to a variety of physical objects, such as valuable papers, rare coins and jewelry), the significant and ever-changing complexities and risks involved with digital assets, we are not certain this history is a reliable indicator of the future. *See* Proposing Release, *supra* note 1, 88 FR at 14692.

[69] See Proposing Release, *supra* note 1, 88 FR at 14705 ("When an asset cannot be maintained with a qualified custodian, a client may not have a full understanding of its holdings or receive periodic account statements reflecting transactions in those assets. This reduces the likelihood that a client will be able to identify suspicious activity in its account or notice that its assets are gone. Moreover, these assets may not be included in the sample of assets subject to verification procedures during a surprise examination or meet the materiality threshold for verification during a financial statement audit. As a result, a loss could similarly go undetected by an independent public accountant for a substantial period.").

the notice from the adviser of any transfer of beneficial ownership of such assets and (ii) notifies the SEC by electronic means directed to the Division of Examinations within one business day upon finding any material discrepancies during the course of performing its procedures;

- The adviser notifies the independent public accountant engaged to perform the verification of any transfer of beneficial ownership of such assets within one business day; and

- The existence and ownership of the client's digital assets that are not maintained with a qualified custodian are verified during the annual independent verification conducted pursuant to paragraph (a)(4) of the Proposed Safeguarding Rule or as part of a financial statement audit performed pursuant to paragraph (b)(4) of the Proposed Safeguarding Rule.[70]

B. Rationale for Adopting Proposed Digital Asset Custodian Exception.

The Proposed Digital Asset Custodial Exception attempts to avoid the burdens and costs described above, while addressing the SEC's concern about the lack of protections and transparency that could result if digital assets were not maintained by a qualified custodian.[71] To address any potential concern that the loss of digital assets excepted from the qualified custodian requirement could be undetected for an indeterminate amount of time, the Proposed Digital Asset Custodial Exception relies heavily on independent public accountants—an approach which mirrors the privately offered securities exception.

IV. The Application of the Proposed Safeguarding Rule to Digital Asset Custody Should Be Clarified.

Unique characteristics of digital assets affect compliance with the Proposed Safeguarding Rule, including the "bearer" nature of private keys, the nearly immutable nature of blockchains, the use of distributed ledger technology to record ownership and the use of asymmetric key cryptography to authenticate transactions.[72]

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[70] As an additional safeguard, the SEC may consider requiring advisers who rely on the Proposed Digital Asset Custodial Exception and that manage a significant level of crypto assets to obtain a written internal control report that includes an opinion of an independent public accountant as to whether controls have been placed in operation as of a specific date, are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by the adviser during the year). The adviser's fiduciary duty would require it to review the report for control exceptions and take appropriate actions where necessary. However, the internal control report would impose additional cost and time obligations on advisers subject to the rule.

[71] The conditions required to satisfy the Proposed Digital Asset Custodian Exception mirror the conditions (suggested by the SEC) for relying on the privately offered securities exception, which conditions were also suggested to improve investor protections in the absence of a qualified custodian.

[72] The SEC and others have commented on these characteristics in the context of the Custody Rule. *See*, *e.g.*, Letter to U.S. Securities and Exchange Commission Division of Investment Management from Polychain Capital LP re Custody Rule and Digital Assets (July 16, 2019), *available at* https://www.sec.gov/files/polychain-capital-lp-071619.pdf (noting, as distinct feature of digital assets, the immutability of blockchain transfers, acquisition of assets through unique usage opportunities, unique distribution mechanisms, and the bearer-like nature of digital assets); *See also* Letter to Karen Barr, Engaging on Non-DVP Custodial Practices and Digital Assets: Investment Advisers Act of 1940: Rule 206(4)-2, *available at* https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206 (noting, as characteristics of digital assets that would affect compliance with the custody rule promulgated under the Investment Advisers Act of 1940, "…the use of DLT to record ownership, the use of public and private cryptographic key pairings to transfer digital assets, the 'immutability' of blockchains, the inability to restore or recover digital assets once lost, the generally anonymous nature of DLT transactions, and the challenges posed to auditors in examining DLT and digital assets.").

We request additional clarity regarding compliance with the Proposed Safeguarding Rule in the context of digital asset custody, given these unique characteristics.

A. The Proposed Safeguarding Rule Should Clarify How a Qualified Custodian May Possess Or Control Certain Digital Assets.

In describing how a qualified custodian may satisfy the "possession or control" requirement with respect to digital assets, the Proposed Safeguarding Rule notes that a qualified 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."[73] However, frequently-cited literature on the subject suggests that digital asset wallets are functionally incapable of holding crypto assets. The digital asset controlled by a private key exists on the distributed ledger governed by the protocol of the applicable blockchain, while cryptocurrency wallets may hold encrypted copies of private keys, public keys and copies of the distributed ledger.[74]

Given the authoritative resources on the subject, we respectfully request clarification that a qualified custodian would have possession or control of a crypto asset if it generates and maintains private key(s) that control the asset in such a manner that an adviser is unable to change beneficial ownership of such asset without the custodian's involvement.[75]

[73] Proposing Release, *supra* note **Error! Bookmark not defined.**, 88 FR at 14689 (emphasis added). Note that unlike other assets, an owner of a crypto asset generally only controls the private key (or sufficient private key material) associated with that crypto asset, while the blockchain is arguably the infrastructure that "holds" the asset. 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 ("Because of the nature of cryptographic assets, access to asset private key material is equivalent to access to the underlying assets (what we mean by digital assets having a 'bearer nature')").

[74] *See* ANDREAS M. ANTONOPOULOS & DR. GAVIN WOOD, *Quick Glossary, in* MASTERING ETHEREUM, *available at* https://github.com/ethereumbook/ethereumbook/blob/develop/glossary.asciidoc (defining the term "wallet" as "[s]oftware that holds secret keys" and noting that "[d]espite the name, wallets never store the actual coins or tokens."); *see also* CONG. RSCH. SERV., IF 12079, *Digital Wallets and Selected Policy Issues* (2022), *available at* https://crsreports.congress.gov/product/pdf/IF/IF12079 (noting that [non-custodial cryptocurrency wallets] "maintain the keys necessary to access and sign" crypto assets.); *see also* ANDREAS M. ANTONOPOULOS*, Transactions, in* MASTERING BITCOIN, *available at* https://github.com/bitcoinbook/bitcoinbook/blob/develop/ch06.asciidoc (noting that "[w]hen we say that a user's wallet has 'received bitcoin', what we mean is that the wallet has detected an [unspent transaction output, or UTXO] that can be spent with one of the keys controlled by that wallet…The wallet calculates the user's balance by scanning the blockchain and aggregating the value of UTXO the wallet can spend with keys it controls."); *see also* Office of the Comptroller of the Currency, Interpretive Letter #1170 (July 2020), *available at* Interpretive Letter 1170, Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (occ.gov) ("[Cryptocurrencies] exist only on the distributed ledger on which they are recorded."); *see also Demystifying cryptocurrency and digital assets*, PwC *available at* https://www.pwc.com/us/en/tech-effect/emerging-tech/understanding-cryptocurrency-digital-assets.html (last visited Mar. 22, 2023) (this source, which is cited by the Proposing Release, notes that "Wallets help store your keys securely so that only you can access your digital assets, and they give you a convenient place to view your assets and ledger positions. This is an important distinction: the digital asset is stored on the blockchain ledger, and the keys that give you access to it are stored in a wallet.").

[75] On a related note, we understand that a qualified custodian's ownership of a private key is not the only way to control a digital asset in a manner such that an adviser is unable to change beneficial ownership without the custodian's involvement. We understand that variations of secure multi-party computation technology, for example, allow a qualified custodian to control sufficient *private key material* to control a digital asset in such a manner such that an adviser with insufficient *private key material* to control such asset would not be allowed to change the beneficial ownership of such asset without the custodian's involvement. We recommend the SEC investigate this area further to determine whether the reference to "private keys," standing alone, is sufficient.

B. The Proposed Safeguarding Rule Should Clarify "Possession or Control" of DeFi Investments.

The DeFi ecosystem seeks to replicate aspects of traditional financial markets, such as borrowing, lending and insurance, without intermediaries. This ecosystem leverages decentralized applications ("**DApps**"), which generally combine "smart contracts"[76] and user interfaces. Private fund managers may engage in DeFi-related investment activities[77] to, among other things, create synthetic versions of real-world assets, lend, borrow, hedge, stake and implement cryptocurrency arbitrage strategies.[78]

Smart contracts have such a commanding role with respect to DeFi investments (and their associated DeFi protocol tokens governed by smart contracts) that they may prevent a qualified custodian from complying with Proposed Safeguarding Rule—notwithstanding the fact that a qualified custodian can prove exclusive control over the private key corresponding to such DeFi protocol token. Simply put, a qualified custodian's control over a private key associated with a DeFi protocol token governed by a smart contract will not, in and of itself, allow it to withdraw, transfer or otherwise control the LP token. While a qualified custodian may seek to control a DeFi protocol token with a private key, we think it is more accurate to say that "control" lies in the hands of the qualified custodian *and* the smart contract governing the DeFi protocol token. The U.S. Department of the Treasury's recently issued risk assessment appears to grasp the issue, and raises additional concerns.[79]

In light of the role played by smart contracts in certain DeFi-related investments, we request that the Proposed Safeguarding Rule clarify whether a qualified custodian may have possession or control over a DeFi protocol token simply by maintaining the private key associated with such token.

C. The Proposed Safeguarding Rule Should Clarify Why Transactions on Public, Permissionless Blockchains Fail to Satisfy the Privately Offered Securities Exception.

The Proposing Release notes that crypto securities transactions on public, permissionless blockchains would not satisfy the conditions for the privately offered securities exception because the transactions involving such assets are "generally evidenced through public keys or wallet addresses."[80] It is unclear why this is the case, as there may be a fact pattern where ownership (the name of the person controlling the private key associated with the address to which a digital asset is sent) is only recorded in the non-public books of the issuer, despite the fact that there is evidence of the pseudonymous transaction that is publicly available (i.e., can be seen using a block explorer).

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[76] A smart contract is a self-executing program that has been deployed to an address on the blockchain. Importantly, smart contracts are not controlled by a user and do not have private keys. Rather, they are owned and controlled by the logic of their smart contract code. Users interact with a smart contract by submitting transactions that execute a function defined on the smart contract. *See* ANDREAS M. ANTONOPOULOS & DR. GAVIN WOOD, *Ethereum Basics, in* MASTERING ETHEREUM, *available at* https://github.com/ethereumbook/ethereumbook/blob/develop/02intro.asciidoc.

[77] We use the term "DeFi-related investment activity" to encompass any investment involving the use of a DApp.

[78] *See* Oscar Saunders, *Custody Rule Dilemmas in DeFi Investing,* HEDGE FUND L. REP. *(Sep. 29, 2022), available at* https://www.hflawreport.com/19447461/custody-rule-dilemmas-in-defi-investing.thtml.

[79] U.S. Department of the Treasury, Illicit Finance Risk Assessment of Decentralized Finance (April 2023) at 15, *available at* https://home.treasury.gov/system/files/136/DeFi-Risk-Full-Review.pdf (noting that while some DeFi services claim that users retain control over their assets during interactions with the DeFi services, many users are required to lock their virtual assets in a smart contract and, in some cases, holders of administrative keys to a smart contract "may have effective control over participant assets.").

[80] See Proposing Release, *supra* note 1, 88 FR at 14706.

We greatly appreciate the opportunity to share with the Commission our comments concerning the Proposed Safeguarding Rule. If the Commission would find it helpful and appropriate, we would welcome the ability to discuss with the Commission this Letter and our related thoughts and feedback. We may be reached by contacting Jeffrey Cohen (jeffrey.cohen@linklaters.com; tel: +1 212 903 9014), Joshua Ashley Klayman (joshua.klayman@linklaters.com; tel: +1 212 903 9047), Oscar Saunders (oscar.saunders@linklaters.com; tel: +1 212 903 9164) or Erika Cabo (erika.cabo@linklaters.com; tel: +1 212 903 9241).

Very truly yours,

/s/ Linklaters LLP

Linklaters LLP