BLOCKCHAIN ASSOCIATION

October 27, 2023

Via E-mail (rule-comments@sec.gov)

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Safeguarding Advisory Client Assets (Release No. IA-6384; File No. S7-04-23; Fed. Reg. No. 2023–18667)

Ms. Countryman:

Blockchain Association (the "Association") submits this letter in response to the Securities and Exchange Commission's (the "SEC") reopening of the comment period for its proposal to amend and replace Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), with Rule 223-1 (the "Proposed Rule"). The Association previously submitted a comment letter in response to the Proposed Rule on May 8, 2023 (the "First Comment Letter").[1]

The Association is the leading nonprofit membership organization dedicated to promoting a pro-innovation policy environment for the digital asset economy. The Association endeavors to achieve regulatory clarity and to educate policymakers, regulators, courts, and the public about how blockchain technology can pave the way for a more secure, competitive, and consumer-friendly digital marketplace. The Association represents over 100 member companies reflecting the wide range of the dynamic blockchain industry, including software developers, infrastructure providers, exchanges, custodians, investors, and others supporting the public blockchain ecosystem.

On August 23, 2023, the SEC adopted final rules under the Advisers Act that affect private funds and their sponsors by restricting or requiring extensive disclosure of preferential treatment granted in side letters, as well as imposing numerous additional reporting and compliance requirements (the "Private Fund Rules"). One of the new rules requires that a registered investment adviser providing investment advice to a private fund must cause that fund to undergo a financial statement audit that meets the requirements set forth in paragraphs (b)(4)(i) through (b)(4)(iii) of the Custody Rule (the "Audit Provision"). The SEC reopened the comment period for the Proposed Rule in light of this change.

[1] Jake Chervinsky and Marisa T. Coppel, *Comment Regarding Safeguarding Advisory Client Assets (Release No. IA-6240; File No. S7–04–23; Fed. Reg. No. 2023–03681)*, Blockchain Association (May 8, 2023), https://www.sec.gov/comments/s7-04-23/s70423-185679-339882.pdf.

The Association writes again to highlight serious concerns regarding the detrimental and discriminatory impact that the Proposed Rule and proposing release (the "Release")[2] would have on the digital asset ecosystem, including describing why the proposed changes to the Audit Provision are unworkable.

I. The SEC Should Revise the Proposed Rule in Response to the Concerns Raised in the Association's First Comment Letter.

The Association maintains that the Proposed Rule suffers from significant deficiencies that require immediate revision. First and foremost, the Proposed Rule would actually ***reduce protections*** for advisory clients who invest in digital assets, the opposite of its intended effect. Consequently, the proposal represents an improper departure from the SEC's position of neutrality on the merits of investments and its overarching mission to protect investors. Even putting the practical effects aside, if adopted, the Proposed Rule likely exceeds the authority granted to the SEC by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amendments to the Advisers Act. Unfortunately, this is one of several legal shortcomings that are apparent on the face of the Proposed Rule and the Release, including failures to comply with the Administrative Procedure Act (the "APA"). Each of these issues are briefly addressed below, and are outlined more fully in the First Comment Letter.

A. The Proposed Rule Will Reduce Protections for Advisory Clients that Invest in Digital Assets.

The Proposed Rule would expose advisory clients that invest in digital assets to ***new costs and risks*** in at least two ways: (1) through the application of rules relating to the use of "qualified custodians" that appear designed to dissuade both advisers and providers of custodial services from accepting clients who invest in digital assets, which would leave these investors with fewer resources than those who invest in traditional assets, and (2) by creating uncertainty for state-chartered banks who might otherwise serve as qualified custodians by requiring them to segregate client funds into an account "designed to protect such assets from creditors of the bank or savings association[,]" which may be impossible under state law.

The Proposed Rule would require that investment advisers with custody of digital assets maintain those assets with a "qualified custodian."[3] But the Release makes several comments that cast doubt on whether an investment adviser to clients invested in digital assets could ever hope to comply with this requirement, creating what Commissioner Mark T. Uyeda correctly characterized as a "no-win" scenario.[4] For example, the Release highlights that while some banks have developed custodial practices for crypto assets, their federal regulators have questioned the "safety and soundness" of crypto-asset-related activities and exposures.[5] Similarly, the Release notes that state-chartered trust companies (which can, under the Proposed Rule, serve as qualified custodians) may not be "regulated to provide [ ] the types of protections [the SEC

[2] Safeguarding Advisory Client Assets, Release No. IA-6240, Fed. Reg. No. 2023-03681 (Mar. 9, 2023).
[3] *See* Release at 41.
[4] Commissioner Mark T. Uyeda, Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets (Feb. 15, 2023), available at https://www.sec.gov/news/statement/uyeda-statement-custody-021523.
[5] Release at 75.

believes] a qualified custodian should provide under the rule."[6] The implication is that an investment advisor *could* use these institutions as qualified custodians, but at his or her own risk, and may be viewed through an antagonistic lens by regulators. This uncertainty will leave investment advisors unfairly exposed, having never been told the concrete standards by which they will be judged by the SEC.

These statements provide a grim backdrop for extensive new requirements for qualified custodians, including that they enter into a written agreement to indemnify clients against losses caused by simple negligence and secure insurance coverage for the same. The combined effect of these changes would be to drive digital asset-native qualified custodians out of the business.[7] By squeezing the number of qualified custodians, the SEC would force investors to remove their digital assets from entities that, despite having developed innovative safeguarding procedures for those assets, will be unable to continue to provide custody services. This would be a big deal: custodying digital assets is a highly technical project that bears little resemblance to its paper and ledger counterparts. Few qualified custodians are technically advanced enough to do it safely. Preventing investors from using their services will, in the SEC's own words, put their digital "assets at a greater risk of loss."[8]

The Proposed Rule's segregation requirement would similarly shrink protections for investors, by failing to allow the flexibility that is currently provided to advisers to assure that their clients' assets are safe in the event of insolvency or bank failure.[9] Instead, the contours of the requirement would be dictated by highly variable state-law standards. In some jurisdictions, it may be impossible for custodians to know what is required to create an account that protects client assets from bank creditors, because no clear guidelines currently exist.[10] The one-size-fits-all approach of the Proposed Rule does not allow investment advisers to make reasoned judgments about how to best protect their clients' assets. Furthermore, in the face of regulatory uncertainty, many banks or savings associations may simply decide that it is impossible to comply, and that they must stop providing custodial services as a result.

A regulatory body designed to protect investors cannot and should not accept a proposal that would create such extensive risk exposure for investors in digital assets.

B. The Proposed Rule Violates the Advisers Act.

Section 223 of the Advisers Act was added in 2010 via the Dodd-Frank Act. It states: "An investment adviser registered under this title shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe."[11] In the Proposed Rule, the SEC interprets Section 223 as a directive to regulate all "assets," including those that are neither funds nor securities.[12] This interpretation represents an improper expansion of SEC

---

[6] Release at 75-76.
[7] *See* First Comment Letter at Sec. III, A.
[8] Release at 272-73.
[9] First Comment Letter at Sec. III, B.
[10] *See* First Comment Letter at Sec. III, B.
[11] 15 U.S.C. § 80b-18b.
[12] Release at 27.

authority under the Advisers Act, as both the statutory construction of the Act and its legislative history make clear.

For instance, in reference to expanding the application of the Proposed Rule to all assets, the SEC argues that Congress's use of the word "assets" was an explicit and intentional choice meant to "empower[] the Commission to develop rules to protect client *assets* when advisers have custody."[13] But statutory construction demands that readers interpret this word in context.[14] The Advisers Act gives the SEC authority to regulate investment advisers. In the Advisers Act, Congress defined an "investment adviser" as a person who advises others on the value or advisability of investing in securities, or who publishes analyses or reports concerning securities.[15] Therefore, where Section 223—an addition to the Advisers Act—refers to "client assets" it can ***only*** be referring to securities, or the funds that may be used to invest in securities. It is simply a shorthand for the types of client assets normally handled by an "investment adviser" as defined by the statute. The SEC understands this, as the Custody Rule has applied only to "client funds or securities" since it was adopted in 1962.[16]

Furthermore, had there been Congressional intent to dramatically expand the types of assets subject to the SEC's authority under the Advisers Act, one would expect that to be clearly reflected in the legislative history of the bill. Here, the use of the term "assets," as opposed to "funds" or "securities," was not discussed in ***any*** official Senate or House report or hearing.[17] That is because the word was chosen "solely for ease of reference" and not, as the SEC now argues, to expand regulatory authority to all assets.[18]

More generally, the Proposed Rule violates the spirit of the Advisers Act, which was designed to respect investment advisers' fiduciary obligation to their clients and adhere to the SEC's position of neutrality on the merits of investments.[19] The Proposed Rule would effectively prohibit a registered investment adviser from: (i) investing in digital assets that cannot be reduced to traditional forms of custody; (ii) participating in non-custodial distributed ledger activities, like staking, that require assets to be deposited in blockchain-based smart contracts that are not administered by a central intermediary; and (iii) transacting through digital asset exchanges that are themselves non-qualified custodians. Essentially, investment advisers would be blocked from providing services related to digital assets. Prohibiting access to advisory services to an entire class of assets is far from neutral, and is an encroachment on investment advisers' ability to perform their fiduciary duty to individual clients with varied financial goals.

---

[13] *Id*. (emphasis in original).
[14] *Maracich v. Spears*, 570 U.S. 48, 65 (2013) ("It is necessary and required that an interpretation of a phrase of uncertain reach is not confined to a single sentence when the text of the whole statute gives instruction as to its meaning.")
[15] 15 U.S.C. § 80b-2(a)(11) ("'Investment adviser'' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities").
[16] *See* Custody or Possession of Funds or Securities of Clients, 27 Fed. Reg. 2149 (Mar. 6, 1962).
[17] *See id*.
[18] Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968, 75 FR 1456, 1456 n.2 (Jan. 11, 2010).
[19] *See* First Comment Letter at Sec. II, B-C.

C. The Proposed Rule Exceeds the SEC's Regulatory Authority Under the APA.

The Proposed Rule's significant curtailment of an adviser's ability to engage in digital asset investment activities would contravene the APA, which requires courts to set aside agency actions that are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[20] As the Association detailed in the First Comment Letter, the Proposed Rule is underpinned by insufficient analysis and arbitrary reasoning.[21]

The Proposed Rule is likely to be deemed arbitrary and capricious if subjected to a legal challenge. This is due to the fact that the SEC neglected its duty under the APA to determine the likely economic consequences of the rulemaking.[22] Agencies must "assess both the costs and the benefits of [an] intended regulation," "propose or adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs," and make decisions based on "the best reasonably obtainable scientific, technical, economic, and other information concerning the need for, and consequences of, the intended regulation."[23] Unfortunately, the SEC fell well short of this requirement, and failed to adequately address the increased costs that the Proposed Rule will impose on qualified custodians, investment advisers, and ultimately, investment clients.[24]

Furthermore, the SEC's statement in the Release that "most [digital] assets are likely to be funds or digital asset securities covered by the current rule"[25] establishes a binding norm under the APA, and must therefore be subject to a notice and comment period.[26] As Commissioner Peirce noted in her statement, this policy position seems "designed for immediate effect, a function proposing releases should not play."[27] In other words, rather than presenting a potential rule change subject to notice and comment, this statement appears to articulate an existing (but previously unstated) policy position. Though the effect of this position is sweeping, the SEC attempts to sidestep the necessary analysis and simply shoehorn its new interpretation into the Release. This type of maneuvering is specifically prohibited under the APA.[28] Having provided neither a reasoned basis for the position, nor opportunity for market participants to voice their concerns, the SEC must immediately rescind the statement.

---

[20] 5 U.S.C. § 706(2)(A), (C)–(D).
[21] *See* First Comment Letter Sec. IV.
[22] *See* First Comment Letter Sec. IV, B.
[23] Exec. Order No. 12,866, 3 C.F.R. 638 (1993).
[24] *See* First Comment Letter Sec. IV, B.
[25] It is also worth noting that this sentiment has been directly challenged by federal courts. *See, e.g.*, *SEC v. Ripple Labs, et al.*, 20-cv-10832 (S.D.N.Y. 2023); *Risley v. Universal Navigation Inc., et. al.*, 22-cv-02780 (S.D.N.Y. 2023).
[26] *Id*. at Sec. IV, C.
[27] Commissioner Hester M. Peirce, Statement on Safeguarding Advisory Client Assets Release (Feb. 15, 2023), available at https://www.sec.gov/news/statement/peirce-statement-custody-021523.
[28] *See* 5 U.S.C. § 553; *see also Connecticut Light & Power Co. v. NRC*, 673 F.2d 525, 528 (D.C. Cir. 1982) ("The process of notice and comment rule-making is not to be an empty charade. It is to be a process of reasoned decision-making. One particularly important component of the reasoning process is the opportunity for interested parties to participate in a meaningful way in the discussion and final formulation of rules."); *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2217, 2125 (2016) ("Agencies are free to change their existing policies as long as they provide a reasoned explanation for the change.").

D. The Proposed Rule Violates the Major Questions Doctrine.

The major questions doctrine dictates that an agency oversteps its jurisdiction where it attempts to assert regulatory authority over questions of major political and economic significance without clear permission from Congress.[29] The economic significance of the digital asset industry is self-evident: 20 percent of Americans own digital assets, and the combined value of all existing cryptocurrency—as of August 28, 2023—is estimated at over one trillion dollars.[30] How those assets are custodied raises novel and complex questions that will have critical implications for millions of Americans. Congress has acknowledged that it is the only appropriate body to address these questions by repeatedly considering bills that tackle the status of digital assets within existing regulatory frameworks.[31] In the absence of a directive from Congress, the Proposed Rule represents an inappropriate attempted extension of the SEC's authority, and should therefore be rejected.

II. The Self-Custodial Exception Should be Revised to Increase Flexibility and Reduce Market Friction.

In light of the finalization of the Private Fund Rules, it is important to ensure any audit requirements of the Proposed Rule are reasonable and workable. As discussed above, under the Proposed Rule, investment advisers with custody of client assets would be required to maintain those assets with a qualified custodian.[32] However, there is a narrow exception whereby assets that are "unable to be maintained with a Qualified Custodian"[33] can be self-custodied by the adviser. Currently, the proposed exception would only apply to privately offered securities or physical assets[34] and be subject to rigorous conditions ("Self-Custodial Exception").[35] The Self-Custodial Exception should be reworked to increase flexibility for advisers, including to address the issues outlined below.

A. The Notice Requirements for the Self-Custodial Exception are Overly Burdensome.

The Proposed Rule states that where an adviser determines that an asset is eligible for self-custody, the adviser would have to adhere to new notice requirements meant to enhance the safety of the asset. The adviser would be required to enter into a written agreement with an independent public accountant whereby (i) the adviser would notify the accountant of any purchase, sale, or other transfer of beneficial ownership within one business day and (ii) the

---

[29] *West Virginia v. EPA*, 142 S. Ct. 2587 (2022).

[30] Coinbase, New survey of 2,000+ American adults suggests 20% own digital assets and the vast majority see an urgent need to update the financial system (Feb. 27, 2023), https://www.coinbase.com/blog/new-national-survey-of-2-000-american-adults-suggests-20-of-americans-own; Bankrate, Cryptocurrency statistics 2023: Investing in crypto (Jan. 5, 2023), https://www.bankrate.com/investing/cryptocurrency-statistics/.

[31] *See, e.g.*, Lummis-Gillibrand Responsible Financial Innovation Act, 117 S. 4356 (2022), Digital Commodities Consumer Protection Act, 117 S. 4760 (2022), Digital Commodity Exchange Act, 117 H.R. 7614.

[32] Release at 41.

[33] *Id* at 127.

[34] The Association calls for an expansion of the Self-Custodial Exception to allow advisers to self-custody any assets that cannot be reasonably held with a Qualified Custodian. *See* First Comment Letter at 8.

[35] Release at 127.

accountant would verify each transfer and notify the SEC within one business day upon finding any material discrepancies.[36]

As an initial matter, these notification requirements are unduly burdensome and unnecessary. In order to comply, accountants would essentially have to be on call 24 hours a day, seven days a week to verify transfers, a level of integration into the business that may implicate industry ethics and independence rules. Furthermore, the requirement to report any transaction within a single business day would put a significant strain on the time and resources of accountants, and would consequently drive up costs for advisers and their clients. The SEC states that this reporting standard is meant to "reduce the likelihood that any loss would go undetected for an extensive time[,]"[37] but quarterly or even monthly reporting would achieve the same goal. The SEC should decrease the cadence of this reporting requirement.

Similarly, the SEC should allow accountants who identify a remediable material discrepancy to notify the adviser of the discrepancy *before* reporting it to the SEC. Advisers should be given the opportunity to explain or cure minor discrepancies before the matter is escalated to the SEC. As written, the Proposed Rule would distract SEC staff and advisers alike with running down curable errors that do not rise to the level of a federal review. Importantly, the SEC has failed to provide any evidence that existing safeguards have failed or that immediate verification of assets would correct a gap in investor protections.

B. The Requirement That Auditors Must Verify Each Asset Is Prohibitively Expensive.

The Proposed Rule would require advisers relying on the Self-Custodial Exception to either undergo an annual surprise examination or rely on the Audit Provision. Under either option, the Proposed Rule would require that each and every privately offered security or physical asset not held with a qualified custodian be verified by an independent auditor.[38] This change would be enormously expensive for all market participants. By the SEC's own estimate, the cost of this change would reach nearly a third of a billion dollars.[39] But this amount does not fully capture the significant costs that would be undertaken by both advisers and independent public accountants if the Proposed Rules is adopted.

In order to complete this level of verification, auditors would need to develop processes to collect and store the required data, verify completeness and accuracy, and report their findings in the annual surprise examination or audit. To the extent that these requirements are or will be applicable to digital asset transactions, the volume of transactions would almost certainly mean that auditors will need to hire additional personnel to comply. Therefore, even a cursory review of the changes necessary to meet these new requirements makes clear that the costs would exceed the SEC's estimate of $60,000 per audit.[40] This is not particularly surprising, given that

---

[36] *Id*. at 309-10.
[37] *Id*. at 143.
[38] Release at 146.
[39] *Id*. at 367 (4,713 (SEC's estimated number of advisers subject to the exception relying on the audit provision) x $60,000 (SEC's estimated cost of audit)).
[40] *Id*. at 319.

the SEC based its estimate on its own "experience" and nothing more,[41] a clear violation of its obligations under the APA.[42]

The SEC has also failed to articulate why using a representative sample as the basis of a surprise examination or an annual audit is insufficient such that this proposal is in any way justified given its cost. Given the inadequacy of the underlying economic analysis and the absence of a reasonable basis for the change, this proposal should be abandoned.

C. The Requirement that Advisers Must Have a "Reasonable Belief" that Auditors Will Perform Under a Written Agreement is Redundant and Ambiguous.

Where an asset is eligible for self-custody, and the adviser has entered into a written agreement with an independent auditor to perform an annual surprise examination (as opposed to an audit), the Proposed Rule would require the adviser to have a "reasonable belief" that the auditor will actually perform under the agreement.[43] "Entering into the contract with the accountant alone would not satisfy the rule."[44]

Given that the point of executing a contract is to ensure that each party will perform under its terms, this requirement is exceptionally redundant. It is unclear what could possibly be used to form the basis for the desired "reasonable belief" outside of the four corners of the signed contract. The SEC uses the example that an adviser should check that its auditor has access to the SEC's filing system in order to determine whether the auditor is planning to perform.[45] But one does not necessarily follow the other. Certainly, the fact that an auditor has access to the SEC's filing system does not provide stronger evidence of an intent to comply than the signed contract itself. In other words, where there is a contract in place, the "reasonable belief" will be self-evident. The SEC should do away with this requirement.

D. Elements of the Audit Provision are Overly Burdensome and May Price Out Smaller Firms.

As an alternative to the surprise examination, advisers to certain types of clients can instead undergo an annual financial statement audit. The Proposed Rule would make certain adjustments to this Audit Provision, which should be revised to accommodate smaller investment advisory firms that may be priced out of compliance if the proposal is accepted as written.

First, the requirement that audited financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP"), or contain information substantially similar to statements prepared in accordance with U.S. GAAP, reconciling any material differences, is inflexible. For entities with a principal place of business outside of the United

---

[41] *Id*.
[42] Exec. Order No. 12,866, 3 C.F.R. 638 (1993); *see also Dickson v. Sec'y of Def.*, 68 F.3d 1396, 1404 (D.C. Cir. 1995) (The arbitrary and capricious standard of the APA "mandat[es] that an agency take whatever steps it needs to provide an explanation that will enable the court to evaluate the agency's rationale at the time of decision.").
[43] Release at 175-76.
[44] *Id*.
[45] *Id*. at 176.

States, this proposal would likely result in their having to pay for two different sets of audited financial statements depending on local jurisdictional requirements.[46]

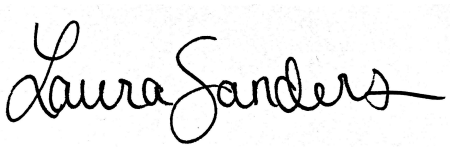
Second, to the extent the changes do or will apply to digital asset transactions, the Proposed Rule would increase reliance on the small number of qualified accountants who are able to perform top-to-bottom audits demanded. As the SEC observes, "[i]f the supply of qualified independent public accountants is scarce relative to any increased demand for their services as a result of this requirement, the overall cost of their services would also increase, at least temporarily until those higher prices attract new entrants into the public accounting market." This is not a hypothetical, this is the actual situation facing smaller advisory firms who may soon be unable to afford to comply with the Proposed Rule. Shrinking the number of available investment advisers would not increase investor protections.

* * *

The Association encourages the SEC to revise the Proposed Rule in light of the considerations outlined above. We welcome the opportunity to discuss our comments with the SEC and its staff and stand ready to work together with the agency to develop a constructive regulatory regime for this industry that fosters innovation and protects investors and market participants.

Respectfully submitted,

Marisa T. Coppel
Senior Counsel



Laura Sanders
Policy Counsel

[46] *See* Comment to File No. S7-04-23 from Deloitte & Touche LLP, May 3, 2023, available at https://www.sec.gov/comments/s7-04-23/s70423-183280-336642.pdf.