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May 25, 2021

Re: Custody Rule and Digital Assets

Directors ten Siethoff and Szczepanik:

We thank the staffs of the U.S. Securities and Exchange Commission’s (“Commission”) Division of Investment Management (“IM” or the “Division”) and Office of Strategic Hub for Innovation and Financial Technology (“FinHub”) for inviting industry comments to inform their recommendations for potential amendments to Rule 206(4)-2 (the “Custody Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”).

We believe cryptocurrency and related blockchain technologies create platforms for innovation and growth that can power tremendous entrepreneurial activity and economic growth in the United States. In order to realize this potential for innovation and growth, the United States needs a clear body of regulations that take into account the unique aspects of digital assets. We believe further clarity around the application of the Custody Rule to digital assets will be an important component of the growth and success of the burgeoning crypto economy in the United States.

In this spirit, we offer the following comments in response to the Division’s and FinHub’s November 9, 2020 “Staff Statement on [Wyoming] Division of Banking’s ‘NAL on Custody of Digital Assets and Qualified Custodian Status’” (the “Staff Statement”).¹

Background

Coinbase was founded in 2012 as a consumer platform that makes it easy to purchase, sell, and transact in cryptocurrency. Our business was founded on the premise that cryptocurrency—and the open, global network upon which it is built—creates unprecedented opportunities to accelerate financial services innovation and enhance consumer access throughout the global financial system. Coinbase was among the first regulated cryptocurrency exchanges in the United States and today is regulated under

¹ Available at <https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets>.

myriad federal and state regulatory regimes, including money transmission regulation, lending regulations and bespoke virtual currency regulation. More immediately relevant to this letter, Coinbase operates a regulated custodial entity, Coinbase Custody Trust Company, LLC (“Coinbase Custody”), which is a New York state-chartered limited purpose trust company that was established in October 2018 under the New York Banking Law.

Over the past eight years, we have witnessed and participated in the tremendous growth of cryptocurrencies and decentralized networks. Most recently, Coinbase became the first major cryptocurrency company to list its shares on a U.S. stock exchange. Today, Coinbase operates the largest cryptocurrency exchange in the U.S., and one of the largest cryptocurrency exchanges in the world. We support over 56 million verified users across more than 100 countries who, in the last quarter, have traded over \$330 billion in cryptocurrency on our platform. Clients entrust us to secure over \$220 billion of their assets. Our more than 1,700 employees—mostly based in the U.S.—are devoted to creating the safe and reliable cryptocurrency services that our clients expect.

Throughout this period of tremendous growth, Coinbase has worked diligently to create a secure and regulated part of the emerging infrastructure of the global cryptocurrency economy. During much of this time, we have worked closely with staff of the Commission, other regulators, law enforcement, banks, and technologists to provide a safe and trusted environment in which consumers and institutional investors can access and trade cryptocurrencies. Coinbase welcomes this opportunity to continue its work with Commission staff and looks forward to IM’s and FinHub’s forthcoming recommendations for potential amendments to the Custody Rule.

Comments

I. New York State Chartered Trust Companies are Qualified Custodians²

Where the provision of non-discretionary custody is a fiduciary activity under state law, the provision of non-discretionary custody should be deemed to satisfy the requisite use of fiduciary power for purposes of determining that a trust company is a “bank” as defined in the Advisers Act. Accordingly, a trust company for which a substantial portion of its business consists of such activity is a “qualified custodian” for purposes of the Custody Rule.

We review below the requirements for a trust company to be deemed a bank for purposes of the Advisers Act and the impact of the recent guidance issued by the Office of the Comptroller of the Currency (“OCC”) on this analysis. Although we specifically consider the status of a New York state-chartered limited purpose trust company in this framework, we believe that an amendment to the Custody Rule should broadly address all state trust company structures in which the powers exercised by a trust company are considered fiduciary at the state level.

The Custody Rule’s definition of “qualified custodian” includes several types of enumerated financial institutions.³ As relevant to state-chartered trust companies, a “qualified custodian” includes a

² This Section I is responsive to the following questions in the Staff Statement: “Do state chartered trust companies possess characteristics similar to those of the types of financial institutions the Commission identified as qualified custodians? If yes, to what extent?”

³ See 17 C.F.R. 275.206(4)-2(d)(6).

“bank,” as defined in Section 202(a)(2) of the Advisers Act. Section 202(a)(2) defines a “bank” to include, in relevant part:

Any trust company that is doing business under the laws of any state, a substantial portion of the business of which consists of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency,⁴ and which is supervised and examined by State authority having supervision over banks or savings associations.⁵

Generally, state-chartered trust companies will satisfy the requirements that the company is doing business under the laws of any state and are supervised and examined by a State authority having supervision over banks or savings associations. In the case of New York state-chartered limited purpose trust companies, they are chartered under the bank and trust company provisions of the New York Banking Law and, therefore, are doing business under the laws of New York. Second, the New York State Department of Financial Services (“NYDFS”), which has supervisory authority over banks and savings associations chartered under the New York Banking Law, supervises, regulates, and examines New York state-chartered limited purpose trust companies.

As described below, the determination of whether the provision of certain services represents the exercise of fiduciary powers similar to those permitted to national banks under the authority of the OCC is contingent on the application of Section 92a of the National Bank Act, the so-called “wildcard statute.”

OCC regulations implementing Section 92a empower national banks to exercise fiduciary powers to the same extent as state-chartered institutions in the state where the national bank is located.⁶ Until recently and as noted in the Wyoming Division of Banking “No-Action Letter on Custody of Digital Assets and Qualified Custodian Status,”⁷ there were differing interpretations of Section 92a —specifically the question of whether a national bank may engage in a fiduciary activity that is permitted for state banks in the state in which the national bank is located where the activity would not be considered a fiduciary activity by the OCC. The answer to this question determines whether non-discretionary custodial services that are authorized as fiduciary activities by a state may be conducted by a national bank, and accordingly whether such activities can satisfy the fiduciary powers requirement under the Advisers Act.

This question has largely been resolved by the OCC in its recent interpretation, OCC Interpretive Letter 1176 (Jan. 11, 2021) (“OCC Interpretive Letter 1176”). OCC Interpretive Letter 1176 concludes

⁴ We refer to “exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency” in this comment as “the Advisers Act fiduciary powers requirement” for ease of reference.

⁵ For purposes of this comment, we assume that New York state-chartered limited purpose trust companies are not operated for the purpose of evading the Advisers Act and, accordingly, have omitted that language from the definition.

⁶ See 12 U.S.C. 92a(a); 12 C.F.R. 9.2(e). See also Custody Services, OCC Comptroller’s Handbook at 11 (January 2002); see also Fiduciary Activities of National Banks, 61 FR 68543 (December 30, 1996) (“The OCC does not treat non-discretionary custodial activities as fiduciary”); OCC Interpretive Letter 695 (December 8, 1995).

⁷ Available at <http://wyomingbankingdivision.wyo.gov/home/pressreleases/twoocanno-actionletterdigitalassetcustodyqualifiedcustodianstatus>.

that “a bank performing in a fiduciary capacity for purposes of state law and operating consistent with the parameters provided for in relevant state laws and regulations may be deemed to be performing in a fiduciary capacity for purposes of 12 U.S.C. § 92a and subject to 12 C.F.R. Part 9.”⁸ Addressing squarely whether there is a separate “threshold” question as to whether activity must qualify first as fiduciary activity under a separate body of law, the OCC Interpretive Letter 1176 goes on to say:

“This [interpretation]...can be contrasted with OCC Interpretive Letter No. 265,... which concluded that the OCC will only look to state law to determine whether a fiduciary capacity of [a] national bank is permissible after the activity is determined to be “fiduciary” within the meaning of 12 U.S.C. § 92a. *To the extent that Interpretive Letter No. 265 conflicts with this decision, it is superseded.*” (italics added for emphasis)

In light of this interpretation by the OCC, we recommend to the Commission that it clarify that for purposes of eligibility to be a “qualified custodian” under the Advisers Act, a “bank” includes any trust company for which a substantial portion of its business consists of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, *which shall include non-discretionary custody where non-discretionary custody is a fiduciary activity under the laws of the state in which the trust company is located.*

With respect to New York state-chartered limited purpose trust companies, non-discretionary custody is such a fiduciary activity. New York law defines custody as a fiduciary activity and authorizes New York state-chartered limited liability trust companies to provide custody services. Under Section 100 of the New York Banking Law, fiduciaries are permitted to “receive, take, manage, hold and dispose of according to the terms of such trust, duty or power, any property or estate, real or personal which may be the subject of any such trust, duty or power.”⁹ Citing this provision, the New York State Banking Department (predecessor of the NYDFS) issued a January 2010 Banking Interpretation (“NY Interpretation”) analyzing whether a New York state-chartered savings bank, authorized to exercise fiduciary powers under New York Law and by the Federal Deposit Insurance Corporation to exercise trust powers, was permitted to provide custodial services for artwork through an operating subsidiary.¹⁰ The New York State Banking Department concluded that, “under its fiduciary powers, the Bank would clearly have the authority to act as a custodian or bailee.” The Advisers Act fiduciary powers requirement therefore is satisfied by a New York state-chartered limited purpose trust company to the extent that custody activities are permissible fiduciary activities under New York state law.¹¹

⁸ OCC Interpretive Letter #1176, 3-4.

⁹ N.Y. Banking Law § 100.

¹⁰ See New York State Banking Department, Memorandum of January 5, 2010.

¹¹ See also NYDFS, Organization of a Trust Company for the Limited Purpose of Exercising Fiduciary Powers, available at https://www.dfs.ny.gov/apps_and_licensing/banks_and_trusts/procedure_certificate_merit_trust_comp. This application guidance states that New York state-chartered limited purpose trust companies “comprise a diverse range of activities under the fiduciary umbrella, such as...custodial services.” The guidance also states that such trust companies include limitations in their organization certificates on permissible activities, with recent chartering documents including this standard clause: “The corporation is to exercise the powers conferred by Section 100 of the Banking Law. The corporation shall neither accept deposits nor make loans except for deposits and loans arising directly from the exercise of the fiduciary powers specified in Section 100 of the Banking Law.” This guidance makes clear that, to the extent a New York

II. New York State-Chartered Trust Companies Enhance the Protection of Client Digital Assets¹²

A. New York State-Chartered Limited Purpose Trust Companies Custody

The legal standards that apply to a New York state-chartered limited purpose trust company and the prudential regulation, supervision, and examination of such entities by NYDFS are comparable to the legal standards that apply to national banks under the authority of the OCC.

The OCC is authorized to charter and supervise national banks under the National Bank Act, which empowers national banks with the requisite OCC approval to exercise fiduciary powers.¹³ The OCC, as well as other federal agencies, is authorized to take enforcement action against a national bank if the national bank engages in an unsafe or unsound practice or violates a law, rule, or regulation.¹⁴ The OCC exercises its supervisory authority with respect to national banks by promulgating regulations that apply to national banks, conducting examinations of national banks, and requiring national banks to submit reports of their financial condition to the OCC in the form of call reports and other mandatory reports.¹⁵ The specific standards that apply to national banks' banking business are derived from a combination of statutes, regulations, and supervisory guidance promulgated by the OCC and other federal and state agencies. The OCC has promulgated regulations and issued supervisory guidance that applies specifically to the custody activities conducted by national banks, including custody of digital assets.¹⁶

Likewise, the New York Banking Law and regulations promulgated by the NYDFS establish an analogous regulatory framework for New York state-chartered limited purpose trust companies, which are chartered and supervised by the NYDFS.¹⁷ The NYDFS is authorized to take enforcement action against a New York state-chartered limited purpose trust company if the trust company violates the New York Banking Law or a regulation promulgated by the NYDFS or engages in an unsafe or unsound act or practice.¹⁸ The NYDFS also supervises New York state-chartered limited purpose trust companies by

state-chartered limited purpose trust company is authorized to engage in custodial activities, its power to do so derives from the fiduciary powers granted to a trust company in Section 100 of the New York Banking Law.

¹² This Section II is responsive to the following question in the Staff Statement: “In what ways are custodial services that are provided by state chartered trust companies equivalent to those provided by banks, broker-dealers, and futures commission merchants? In what ways do they differ? Would there be any gaps in – or enhancements to – protection of advisory client assets as a result of a state chartered trust company serving as qualified custodian of digital assets or other types of client assets?”

¹³ See 12 U.S.C. §§ 1 – 216d; 12 U.S.C. § 92a.

¹⁴ See 12 U.S.C. § 1818.

¹⁵ See 12 C.F.R. § 1 et seq., OCC Supervision & Examination – Examinations, available at <https://www.occ.treas.gov/topics/supervision-and-examination/examinations/index-examinations.html>; 12 U.S.C. § 161(a).

¹⁶ See OCC Interpretive Letter # 1170 (July 2020); 12 C.F.R. § 9.13; OCC Comptroller’s Handbook, Custody Services (Jan. 2002), available at <https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/custody-services/index-custody-services.html>.

¹⁷ See N.Y. Banking Law art. III; N.Y. Banking Law § 102-a.

¹⁸ See N.Y. Banking Law §§ 39, 41, 44.

promulgating regulations that apply to such companies, conducting examinations, and requiring the submission of financial reports.¹⁹ The specific standards that apply to New York state-chartered limited purpose trust companies’ business also are derived from a combination of statutes, regulations, and supervisory guidance promulgated by the NYDFS and other federal and state agencies. New York state-chartered limited purpose trust companies’ custodial activities with respect to digital assets are subject to regulations and supervisory guidance, including requirements tailored to the specific trust company in supervisory agreements.²⁰

B. Digital Asset Custodial Services Differ from Traditional Custody Services

As the Commission itself recently stated, “[t]he technical requirements for... custodying digital asset securities are different from those involving traditional securities... [T]raditional securities transactions often involve a variety of intermediaries, infrastructure providers, and counterparties for which there may be no analog in the digital asset securities market.”²¹ We agree with the Commission that the custodying process for digital assets is materially different from the custodying process for traditional securities transactions. As such, evaluating the critically distinct features of safeguarding digital assets is equally as important as understanding the similarities between the legal standards and prudential regulation of a New York state-chartered limited purpose trust company and national banks. Accordingly, we believe that any proposed amendments to the Custody Rule that accommodate digital assets must focus on the unique aspects of safeguarding such assets.

Coinbase Custody was launched in response to industry demand for a trusted, crypto-forward digital asset custodian. The simple description of Coinbase Custody’s services—the transfer in (deposit) or transfer out (withdrawal) of certain supported digital assets by institutional clients into custodial accounts established on the books and records of Coinbase Custody on behalf of the client²²—belies the technical complexity of the activity. Facilitating deposits and withdrawals requires meticulous processes for encryption (*i.e.*, key generation), secure storage, and decryption.

In order to perform deposits and withdrawals for the supported digital assets, Coinbase Custody has developed very specific, industry-leading practices in its policies, procedures, and controls for safekeeping and maintaining exclusive possession or control over digital assets it custodies to protect against the theft, loss, and unauthorized and accidental use of the private keys necessary to access and transfer the digital assets it holds in custody. For on-boarding and deposits of digital assets, Coinbase performs a private key generation ceremony that is secure and produces a cryptographically strong private key that is compatible with the distributed ledger technology and associated network and that is not susceptible to being discovered by unauthorized persons during the generation process or thereafter. This process includes the offline creation of public/private key pairs and a Coinbase Custody employee, designated as scribe, witnesses and documents every private key generation ceremony. For withdrawals (*i.e.*, decryption), Coinbase requires a multi-party and multi-stage cold restore protocol to sign

¹⁹ See NYCRR, titles 3 and 23; N.Y. Banking Law §§ 14, 36.

²⁰ See 23 NYCRR § 200.9 (Custody and protection of customer assets).

²¹ Securities Exchange Act Release No. 34-90788, available at <https://www.sec.gov/rules/policy/2020/34-90788.pdf> (the “Special Purpose Broker Dealer Statement”).

²² At this time, Coinbase Custody does not process purchase or redemption transactions for clients or otherwise convert their interests in supported digital assets into fiat currency.

transactions and bring digital assets out of cold-storage. Coinbase's decryption ceremony involves multiple independent actors, hardware security tokens, software-based security enforcement, and operational checks and balances. Because of the technical complexity in the decryption process, Coinbase Custody can require up to 24 hours between any request to withdraw digital assets from a client's custodial account and submission of client's withdrawal to the applicable digital asset network. Coinbase stores non-MPC-based shared private keys off-line in a vault protected with constant physical security; with respect to MPC-based private keys, Coinbase stores cryptographic materials off-line and encrypted shards online (in an unusable format). In addition, multi-factor authentication is required to process private key shards and back-up key materials are secured in vault facilities around the globe.

In addition to ordinary deposit, storage, and withdrawal functions of our systems that are utilized to create, store, and use private keys, digital asset custodians need to have processes in place to make determinations about their ability to support infrequent events, such as airdrops, metacoins, colored coins, side chains, or other derivative, enhanced, or forked protocols, tokens, or coins which supplement or interact with a supported digital asset. Coinbase Custody evaluates each of these types of events individually and makes a determination about whether it can be supported.

These processes that Coinbase, like other digital asset custodians, have implemented are designed to protect private keys from being used to make an unauthorized or accidental transfer of a digital asset and to protect private keys from being corrupted, lost or destroyed. The processes involve backing up the private key in a manner that does not compromise the security of the private key, and that otherwise preserves the ability of the firm to access and transfer a digital asset security it holds in the event a facility, software, or hardware system, or other format or system on which the private keys are stored and/or used is disrupted or destroyed.

In general, these processes and controls in aggregate align with the "fourth step" that a broker-dealer can employ to comply with Rule 15c3-3, as described by the Commission in the Special Purpose Broker Dealer Statement. Consistent with Coinbase Custody's role as a trusted custodian of digital assets and the criticality of operational processes that are carefully documented in policies and procedures and subject to effective internal governance and controls, Coinbase Custody maintains a robust system of internal controls related to financial reporting, information and IT security, which are audited regularly by independent service auditors. Coinbase Custody maintains American Institute of Certified Public Accountants ("AICPA") System and Organization Controls ("SOC") reports (SOC 1, Type 2 and SOC 2, Type 2) that attest to the design and effective operation of its controls. The SOC 1 and SOC 2 reports provide our clients (including investment advisers) with a ready, standardized format for evaluating the effectiveness of a potential custodian's control environment.

Together, these key differences between custodial processes for digital assets and custodial services for traditional securities should inform the Division's and FinHub's recommended amendments to the Custody Rule.

III. Principles Should Govern Advisers' Selection of Digital Asset Custodians²³

²³ This Section III is responsive to the following question in the Staff Statement: "...[A]re there qualities that would be important for safeguarding digital assets that might not be important for safeguarding other types of assets? If so, what qualities and why? Should the rule prescribe different qualities based on asset class, or should the rule take a more principles-based approach and allow advisers to exercise care in selecting a custodian?"

As explained above, certain of the qualities that are important for safeguarding digital assets are unique and differ materially from the qualities that are important for safeguarding traditional securities. The criticality of safety and soundness to custodial activities for digital assets weighs in favor of amendments to the Custody Rule that are specifically tailored to digital assets and that set appropriately high standards for qualified custodians of digital assets custodied by registered investment advisers.

In this context, Coinbase believes that a principles-based framework would be a more productive starting point for any broader conversation about potential Custody Rule amendments. The principles should highlight qualities that are of outsized importance for safeguarding digital assets, some of which might be less important for safeguarding securities or other types of assets. As a starting point for such a framework, Coinbase would recommend that qualified custodians for digital assets (or sub-custodians thereof) should, at a minimum, have:

- *Institutional Technical Expertise*. Demonstrated technical expertise in digital assets, as evidenced by the sophistication of its systems, processes, internal controls, and its track record as a digital assets custodian;
- *Personnel with Technical Expertise*. Minimum number of crypto-specific technical personnel with expertise in engineering or technical security (consider requiring engineering and computer science degrees);
- *Minimum Size*. Minimum size could be measured in terms of assets-under-custody, staffing, physical facilities and computing power;
- *Authority to Custody Digital Assets*. Custody of digital assets should be a recognized fiduciary activity of the state-chartered bank or trust company or national bank or trust company;
- *Robust Staffing*. Minimum staffing for key internal functions, including compliance, internal audit, and accounting;
- *Audited Control Environment*. Maintenance of both SOC 1 (Type 2) and SOC 2 (Type 2) reports; and
- *Annual Certified Audits*. Audits performed no less than annually by an independent third party accounting firm.

Conclusion

In conclusion, Coinbase once again welcomes the opportunity to work cooperatively with Commission staff. We support the Division's and FinHub's efforts to provide further clarity around the application of the Custody Rule to digital asset custodial activities. We believe that a Custody Rule specifically tailored to digital assets with appropriately high security standards will be critical to responsibly facilitating increased participation by registered investment advisers in the growing crypto economy in the United States, and that such a rule would advance the Commission's policy goals of protecting investors, facilitating capital formation, and fostering fair, orderly, and efficient markets. We look forward to the Division's and FinHub's next steps on this issue.

Regards,



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cc: Juan Suarez, Coinbase, Vice President, General Counsel - Enterprise
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