May 8, 2023

By electronic submission

Vanessa Countryman, Secretary
United States Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

Re: Comments to Safeguarding Advisory Client Assets Proposed Rule, [Release No. IA-6240; File No. S7-04-23; RIN 3235-AM32]

Dear Ms. Countryman:

We thank the staff of the U.S. Securities and Exchange Commission ("**SEC**") for inviting industry comments to inform their proposed amendments to Rule 206(4)-2 (the "**Custody Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**").

GBBC Digital Finance **("GDF")**, is the leading global members association advocating and accelerating the adoption of best practices for crypto and digital assets. GDF's mission is to promote and facilitate greater adoption of market standards for digital assets through the development of best practices and governance standards by convening industry, policymakers and regulators. GDF leads the global financial service sector as part of the Global Blockchain Business Council ("**GBBC**"), the largest and leading industry association for the blockchain technology and digital assets industry with more than 500 institutional members, and 231 Ambassadors from across 109 jurisdictions and disciplines.

GBBC and GDF offer the following comments in response to the SEC's proposed rule entitled, "Safeguarding Advisory Client Assets," released on February 15, 2023 (the "**Proposed Rule**").[1]

I. Rule Background

The Proposed Rule seeks, among other things, to expand the range of assets that registered investment advisers (each a "**RIA**") are required to hold with "qualified custodians" to clearly include digital assets. The Proposed Rule would also update recordkeeping and reporting requirements, and impose portfolio segregation, among other requirements. In 2021, $128 trillion in assets were managed by 15,000 SEC-registered investment advisers for 64.7 million clients.[2] Accordingly, any changes to rules governing RIAs can have significant impacts on all asset classes, including digital assets.

The Proposed Rule follows statements by federal bank regulatory agencies cautioning banks on digital asset custodial activities,[3] a joint SEC and Financial Industry Regulatory Authority statement expressing

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[1] SEC, Proposed Rule, *Safeguarding Advisory Client Assets*, Release No. IA-6240; File No. S7-04-23 (SEC Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf at p. 269-270.

[2] Investment Adviser Association, *2022 Year in Review*, (IAA 2022), https://investmentadviser.org/wp-content/uploads/2022/12/IAA_2022-Year-in-Review_FINAL.pdf at p. 5.

[3] *See* OCC, Letter, *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* ("OCC Interpretive Letter 1179") (Nov. 18, 2021), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf; *see also* Federal Deposit Insurance Corporation Financial Institution Letter 16-2022 (Apr. 7, 2022) https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html and Board of Governors of the Federal Reserve System Supervisory and Regulation Letter 22-6 (Aug, 16, 2022) https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm.

concerns with digital asset custody,[4] and a 2022 SEC Staff Accounting Bulletin[5] requiring public companies to make certain disclosures and record on their balance sheets a liability and corresponding asset of crypto assets that they are holding as custodian.

This Proposed Rule could have significant practical and strategic implications for digital asset market structure and participants throughout the digital asset ecosystem for years to come.

II. The Proposed Rule Does Not Properly Address the Risk that the Custody Rule is Protecting Against.

In regulating investment advisers' custodial practices, the Custody Rule protects against risks associated with *advisers*' financial reversals with respect to crypto assets, including insolvency, and misdeeds, such as custodial assets being lost, stolen, misused, or otherwise misappropriated. However, the amendments to the Custody Rule may not mitigate these risks, but rather could exacerbate them. Effectively, the Proposed Rule may make it more difficult for some financial intermediaries to participate in crypto-related activities.

Traditionally, the existing Custody Rule has required all RIAs with custody of client funds and securities to deposit client funds in a bank account that was maintained in the adviser's name and contained only client funds. Similarly, RIAs with custody of securities were required to segregate client securities and hold them in a reasonably safe place. In 2003, the definition of custody was expanded to include situations where the advisor had the ability to obtain possession of client funds or securities. Thereafter, Congress vested the SEC with the authority to establish rules requiring RIAs to take steps to safeguard client assets over which they have custody, and not just funds and securities, but all assets.

Now, 20 years later, the SEC proposes amendments to the existing Custody Rule that would have far-reaching implications for investors in crypto assets, their investment advisors, auditors, custodians, and in particular those seeking access to crypto assets. Among other things, the proposal would:

- Expand the assets covered under the Custody Rule to include crypto assets, real estate interests, and commodities, as well as other positions that may not be recorded on a balance sheet as an asset for accounting positions.
- Treat discretionary authority as a form of custody, thereby increasing the number of RIAs deemed to have custody of client assets and, thus, be subject to the Custody Rule.
- As to Foreign Financial Institutions ("**FFI**"), subject them to more requirements, including the segregation of assets, the ability to enforce judgements against them, and being legally subject to anti-money laundering regulations requirements similar to those of the Bank Secrecy Act.
- Require RIAs to enter into written agreements with the qualified custodians holding their clients' assets, and imposing many new recordkeeping and reporting obligations on those custodians.
- Require RIAs to obtain reasonable assurances of certain minimum investor protections from qualified custodians.

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[4] *See* Joint Staff Statement (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 SEC 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").

[5] *See* SEC Staff Accounting Bulletin No. 121 (April 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).

Practical Considerations

As a result of SEC Staff Accounting Bulletin (SAB) No. 121, there will be fewer companies willing to serve as a qualified custodian and, as to those companies, they will have a hard cap on the amount of digital assets that can be custodied. In sum, SAB 121 mandates that reporting companies and certain other companies that safeguard digital assets on behalf of their customers record a liability on their books equal to the fair value of the digital assets, the effect of which is to make it more expensive and difficult for reporting companies to serve as a qualified custodian – and, significantly more difficult for RIAs to find qualified custodians so that they can comply with the Custody Rule. Notably, for regulated banks, SAB 121 effectively creates a limit on the value of the digital assets that a bank may custody due to the balance sheet capital and reserve constraints imposed by the Bulletin. This is because any capital ratio "utilized" by such bank cannot be used for other banking activity. There is no such SAB that applies to other types of assets in custody by reporting and other companies. This rule *only* applies to digital assets and only applies to reporting companies, creating an uneven playing field as non-reporting companies are not subject to such requirements.

Moreover, the amendments add friction to RIAs seeking to trade crypto assets on behalf of their clients. The amendments explicitly provide that discretionary trading authority for an expanded set of assets would be deemed "custody" for RIAs. Because RIAs are responsible for the custody of their clients' assets, they will, therefore, have fewer options for trading digital assets on behalf of clients. Additionally, the available options will be burdensome and expensive.

It is possible that a large swath of RIAs will decline to accept digital assets as part of their clients' investment portfolios, leaving investors to fend for themselves, including off-shoring their investments with less regulated custodians.

Alternatively, left to their own devices, investors will likely self-custody, which comes with its own set of risks such as the possibility of the loss or theft of their private keys. Alternatively, investors might leave crypto assets on the digital exchange where their trades were executed and have the exchange serve as the custodian. This, too, can carry risk.

It will be difficult for RIAs to comply with recordkeeping and auditing requirements. For example, under the Proposed Rule, qualified custodians would be required to provide the RIA with a written internal report that includes an opinion from an independent public accountant as to whether controls have been placed in operation to meet the control objectives related to control services. It is unlikely that there will be sufficient independent public accountants that can provide these required opinions.

In addition, there will be fewer entities able to serve as FFIs under the Proposed Rule due to the imposition of additional conditions and requirements, many of which may not only be inconsistent with requirements imposed by their home jurisdictions, but also unworkable. Moreover, it is unlikely that FFIs will agree to be subject to the SEC's authority since the regulatory frameworks and market practices in the FFI's home jurisdictions provide for the safe keeping of client assets. In addition, we question how the new conditions and requirements in the Proposed Rule will be interpreted and enforced by the SEC. This in turn, will likely result in a period of uncertainty with respect to whether foreign entities actually qualify as FFIs and would constitute qualified custodians under the proposed amendments.

An amendment requiring cash to be held in special deposits at banks – not regular DDA accounts – does not protect against the risk at issue here which goes to whether an RIA may lose or otherwise take improper actions with its client's assets. This requirement of holding funds in special deposits appears to address the risk of whether the bank is sound. Perhaps this type of question is best left to the banking regulators and not the SEC.

The effective date for the Proposed Rule does not provide sufficient notice for RIAs to comply with the proposed changes.

III. If the Proposed Rule Required Crypto Assets to be held by "Qualified Custodians," the SEC Should Provide Guidance on how an Entity May Become a "Qualified Custodian" for SEC Purposes.

We urge the SEC to issue formal public guidance as to whether and under what circumstances an entity can serve as a "qualified custodian" of crypto assets, to allow compliance with the Proposed Rule. Under the Custody Rule, RIAs are required among other things to *custody securities and funds* with persons designated as "qualified custodians."[6] But there is no official registration or application process to inform digital asset custodians whether they can become a "qualified custodian" for SEC purposes. Rather, an entity must have the status of one of the designated regulated intermediaries. There are a series of entities that are considered "qualified custodians" for the purposes of the Advisers Act, including a *bank*, broker-dealer, futures commission merchant or a foreign financial institution.[7] This, too, creates confusion because there are differing interpretations regarding whether a state-chartered trust company may serve as a bank for purposes of becoming qualified custodian.

As relevant to state-chartered trust companies, the Advisers Act states in relevant part that a "bank" is defined as a:

> [A] trust company, … [where] a substantial portion of the business … consists of receiving *deposits or exercising fiduciary powers* similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations[.][8]

There have been differing interpretations regarding whether all state-chartered trust companies should be deemed to be a "bank" for purposes of becoming qualified custodian, because *custodial services* do not always constitute fiduciary activities under the applicable state laws.[9]

Accordingly, we request that the SEC 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.

IV. If the Proposed Rule is Implemented, Certain Requirements will be Difficult to Implement.

In addition to clearly expanding the scope of the Custody Rule to include crypto assets, several additional requirements in the Proposed Rule could make crypto assets custody more difficult:

- Enhanced Custodial Protections. The Proposed Rule would require that a qualified custodian does not "maintain" a client asset for purposes of the rule if it does not have "possession or control" of that asset. It may be difficult to prove exclusive "possession or control" of a crypto

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[6] SEC, Proposed Rule, *Safeguarding Advisory Client Assets*, Release No. IA-6240; File No. S7-04-23 (Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf at p. 269-270.
[7] 17 C.F.R. § 275.206(4)-2(d)(6) (emphasis added).
[8] 15 U.S.C. § 80b-2(a)(2) (emphasis added).
[9] *See e.g.,* State of Wyoming, Division of Banking, *No-Action Letter on Custody of Digital Assets and Qualified Custodian Status,* (Oct. 23, 2020), available at: https://docs.google.com/viewer?a=v&pid=sites&srcid=d3IvLmdvdnxiYW5raW5nfGd4OjU2MDk2ZGQyYjg1ZDUzYTc (The Division found that Two Ocean could serve as a "qualified custodian" under Wyoming Law, based on the definition of "bank" in the Advisers Act and because Two Ocean exercised genuine fiduciary powers as a substantial portion of its business); *see also* U.S. Securities and Exchange Commission, *Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status,"* (Nov. 9, 2020), available here: https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets#_ftnref4 (The SEC emphasized the statement that the Wyoming letter should not be construed to represent the views of the SEC or any other regulatory agency, and the SEC encourages interested parties to engage with the SEC directly).

asset due to the decentralized nature of crypto assets as that asset may live on the underlying blockchain protocol and not with the crypto firm itself (i.e. when a user engages in staking on a cryptocurrency exchange, often the blockchain protocol locks up the token). But there are technological solutions that could address this challenge. For example, Multi-Party Computation (MPC) technology allows a custodian to prove exclusive possession or control of a customer's assets through the maintenance and ownership of key-shares or shards of a customer's private key, which are generated by the MPC address and maintained, encrypted, on physically and logically separate servers. As a result, the qualified custodian, as owner of the necessary partial share of the wider private key, would always be required to be precedent to and effectuate a change in beneficial ownership, eliminating single points of failure that could lead to the unauthorized transfer of funds by the RIA (or anyone else).

- Updated Recordkeeping and Reporting Requirements. The Proposed Rule will also require the qualified custodian to deliver account statements to clients and the adviser as well as promptly provide information to the SEC upon request. While critically important, this may prove to be difficult, if not impossible, given the compressed timing, the lack of available professionals who meet requirements set forth in the Proposed Rule and the lack of clarity in the rule.

- Asset Segregation. Under the Proposed Rule, advisers with custody of client assets will be required to segregate those assets by (1) titling or registering the assets in the client's name, (2) not commingling the assets with the adviser's, and (3) not subjecting the assets to any right, charge, security interest, lien, or claim of any kind in favor of the investment adviser. These are core tenets of client asset protection in traditional finance which we support. We look forward to working with the SEC to address any possible technical and operational challenges presented specifically by crypto assets.

- Strategic Implications and Crypto Assets Market Structure. Most crypto assets trade on platforms that are not qualified custodians. While some trading platforms and others have subsidiary entities that may qualify as qualified custodians, their execution of transactions might not necessarily flow through a qualified custodian as most crypto assets trading platforms, lenders, and other service providers are not generally qualified custodians under the Advisers Act. As a result, to address regulatory requirements, firms may need to restructure their operations, build up or buy qualified custodians or enter into new commercial arrangements with qualified custodians, or forgo access to the $120 trillion in assets managed by RIAs. If adopted as proposed, we expect the Proposed Rule would increase friction, reduce efficiencies and drive business offshore and to jurisdictions with reduced KYC/AML compliance. This, in turn, would increase risk to investors, among others.

V. Recommendations

We urge the SEC to issue guidance with respect to the manner in which crypto assets may be held by a qualified custodian in compliance with the proposed rule. This guidance should be specific and perhaps provide a walkthrough for these impacted individuals.

- 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."[10]

We urge the SEC to propose custody arrangements that would meet the stated goal of the proposed rule (to safeguard client assets) to provide a practical pathway to compliance which includes

[10] Coinbase letter to the SEC, *Custody Rule and Digital Assets*, (May 25, 2021) available at: https://www.sec.gov/files/coinbase-052521.pdf (*citing* the OCC Interpretive Letter 1176 (Jan. 11, 2021), available at: https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1176.pdf ("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.")) (the "Coinbase Letter").

leveraging technological solutions to safeguard crypto assets, such as Multi-Party Computation wallets integrated with exchange platforms. This would allow multiple users to jointly control the digital assets of the wallet without sharing private and critical passwords.

- Certain of the qualities that are important for safeguarding crypto assets are unique and differ materially from the qualities that are important for safeguarding traditional securities, such as, in some cases, the crypto assets' decentralized nature. The criticality of safety and soundness to custodial activities for crypto assets weighs in favor of amendments to the Custody Rule that are *specifically tailored to crypto assets and that set appropriately high standards for qualified custodians of crypto assets in custody by RIAs*.[11]

- In this context, 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 crypto assets, and which, in some cases, may be less important for safeguarding securities or other types of assets.[12]

- As a starting point for such a framework, we would recommend that qualified custodians for crypto assets (or sub-custodians thereof) should, at a minimum, have institutional technical experience evidenced by the sophistication of internal processes and controls; personnel with technical engineering expertise; minimum size of asset-under-control; the custody of crypto assets should be a recognized fiduciary activity of the state-chartered bank or trust company or national bank or trust company; have sufficient compliance functions; and audited control environment.[13]

We urge the SEC to extend the effective date for RIA compliance. In the event the SEC decides to move forward with the Proposed Rule as proposed, RIAs will need more time to come into compliance, if that is even possible. We agree with the comment by LSTA that "advisers and financial institutions serving as qualified custodians will need time to vet the proposal internally and consult with one another and with sub-custodians and other parties that will be impacted by the proposal."[14]

We urge the SEC to ensure that there are crypto-focused qualified custodians that have regulatory approval to allow advisors to utilize their services. The SEC can do this by simplifying the process and working with qualified custodians to develop best practices. Ultimately, if implemented as proposed the stated goal of the Proposed Rule will not be achieved instead, as explained above, U.S. investors will suffer.

We urge the SEC to consider market-based solutions that could help to enhance protection and security for the public, including the use of insurance. Insurance has been recognized by the SEC as a tool to help reduce risk, such as requiring public companies to have cyber insurance.

Finally, we urge the SEC to release guidance as to how FFIs can meet the requirements introduced in the Proposed Rule. Additionally, this guidance should interpret and explain how the SEC will enforce the Rule.

VI. Conclusion

The Proposed Rule is significant and will affect numerous industry participants, including RIAs, investors, custodians of assets, and others. If adopted as proposed without significant changes, the Proposed Rule will restrict the ability of RIAs to interact with crypto assets and will create costly new requirements on crypto asset transactions that will be borne in large part by U.S. investors, RIAs and certain other organizations that will be excluded from serving as qualified custodians. While we agree that protecting U.S. investors is important, we do not believe that the Proposed Rule achieves this result. Therefore, we

[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] https://www.sec.gov/comments/s7-04-23/s70423-20158808-326881.pdf

urge the SEC to be forward-thinking and begin to propose and implement rules and guidance that both protects investors' crypto assets and allows innovation related to crypto assets to flourish in the United States.

GBBC and GDF thank the SEC for its attention, welcomes an open dialogue and urges the SEC to pause any rule implementations until clear guidance is issued on the recommendations above.[15]

Sincerely,

Andrea Tinianow (May 8, 2023 12:08 EDT)

Andrea Tinianow
GBBC Chief Legal Officer and
Head of Policy, Americas

Andrew Smith (May 8, 2023 12:45 EDT)

Andrew Smith, Esq.
GBBC Digital Finance
Government and Regulatory Affairs Director, Americas

[15] GBBC and GDF would also like to thank Paul Hastings LLP and DLx Law for their assistance in developing this comment letter. The Paul Hastings team consists of Eric Sibbitt, Nick Morgan, Larry Kaplan, Dina Ellis Rochkind, Lisa Rubin, and Gabriel Khoury. The DLx Law team consists of Lewis Cohen and Greg Strong.