May 8, 2023

Via Email (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-6240; File No. S7–04–23; Fed. Reg. No. 2023–03681)

Ms. Countryman:

Blockchain Association (the "Association") submits this letter in response to the request for comments by the U.S. Securities and Exchange Commission (the "SEC" or the "Commission") with respect to 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 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.

The Association writes to highlight its concerns with the Proposed Rule and statements made in the proposing release (the "Release") with respect to their impact on the digital asset industry generally.[1] If adopted as proposed, we believe the Proposed Rule would contravene the Advisers Act by significantly curtailing digital asset investment activity and improperly failing to consider the unique technological nature of digital assets. In particular, the expansion of the Proposed Rule to cover all "assets," including digital assets that may not be funds or securities, would exceed 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. Such an assertion of jurisdiction over digital assets is inconsistent with the Dodd-Frank Act legislative history.

Further, the manner in which the Proposed Rule attempts to restrict digital asset investment activity is inconsistent with the principles-based approach set out by Congress in the Advisers Act, which affords investment advisers and advisory clients broad flexibility to shape the scope of

[1] See Safeguarding Advisory Client Assets, Release No. IA-6240, Fed. Reg. No. 2023-03681 (Mar. 9, 2023).

their fiduciary relationships. The Proposed Rule's requirements for qualified custodians in particular would discourage digital asset-native custodians from continuing to provide custodial services, which would reduce, rather than increase, protections for advisory clients. In addition, we believe that the SEC's statement in the Release suggesting that most digital assets are *currently* "funds or securities" under the Custody Rule is at odds with the Administrative Procedure Act (the "APA"). This statement represents a departure from past interpretive positions and imposes a binding norm on market participants that has not been subjected to a proper notice and comment rulemaking in conformance with the APA.

The Proposed Rule would impose insurmountable burdens on custodians who wish to custody digital assets as well as significantly curtail investment advisers' ability to provide digital asset-related services to their clients. The impact of the Proposed Rule would also likely materially harm the digital asset market and its participants by reducing the amount of capital available to entrepreneurs and developers to continue innovating in the United States. The Association urges the SEC to abide by its obligations under the APA, act within the limits of its statutory authority, and consider the unique characteristics of digital assets in formulating any final rule relating to digital asset custody.

I. Digital Assets Are Technologically Distinct from Other Asset Classes.

Digital assets represent a fundamentally distinct—and technologically more advanced—means of transferring and holding assets when compared to traditional asset classes and should continue to be accessible to investors. Unlike other assets, digital assets are units of computer code that function on a decentralized network called a "blockchain."[2] Functioning on a blockchain allows this asset class to benefit from major enhancements when compared to traditional asset classes, including increased transparency and high security, immutability, efficiency, and cost-effectiveness.

Blockchain technology offers a revolutionary upgrade to the traditional financial system, which is reliant upon a limited number of slow and expensive intermediaries who act as gatekeepers and middlemen. Blockchain technology utilizes a consensus mechanism that makes it possible for users to trust that transactions added to the blockchain are valid. Although a blockchain functions like a bank's ledger by recording and tracking each transaction added, a blockchain is distinct from a bank's ledger in that it is not private, modifiable, or subject to a single entity's control. Rather, a blockchain is wholly transparent and immutable, which means that each transaction added is publicly viewable and cannot be changed. Unlike traditional investment classes where investors are reliant upon records held by intermediaries that remain invisible to investors themselves, the public and immutable nature of the blockchain presents far more security and accountability.

Blockchains also offer investors the ability to use their digital assets with more efficiency than traditional assets. Digital asset transactions are relatively fast and allow for more user control over specific transactions because users are able to view an entire chain of transactions without relying on a third party. Users thus have more certainty in settlement and experience shorter waiting times when transacting in digital assets than when transacting in traditional asset classes.

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[2] Shawn Bayern, Of Bitcoins, Independently Wealthy Software, and the Zero-Member LLC, 108 Nw. L. Rev. 1485, 1488 (2014).

Unlike traditional asset classes, digital assets' reliance on cryptography serves as the basis for their benefits. A user stores their digital assets (i.e., the assets stored on the blockchain) in their "wallet," which is associated with the user's "public key" (a series of numbers and letters analogous to an e-mail address). A user's transactions are publicly linked to a user's public key on the blockchain. On the other hand, a user's "private key," which is analogous to a password, is what allows a user to access and use his or her digital assets. For example, if User A wants to send digital assets to User B, User A must have access to his or her own private key and User B's public key. There is a cryptographic link between a user's private key and public key. An investment adviser may maintain a client's private key to be able to invest that client's digital assets.

Of course, as with traditional asset classes, it is possible for a party other than the owner of the assets to custody the assets on behalf of the owner. The technology required to safely custody digital assets continues to evolve, but already presents options that are far more technologically advanced than the technology used to custody traditional asset classes. For example, with Multi-Party Computation ("MPC") technology, private keys no longer need to be stored in a single place, which reduces the possibility of the private keys being subject to a single point of compromise. When private keys are stored in a single place, the user must trust that the party holding the private key has adequate security measures. But with MPC technology, the private keys are broken up into shards, encrypted, and divided among multiple parties. Each party then independently computes his or her part of the private key to produce a signature without revealing his or her portion of the private key to the other parties. This technology thus eliminates the risks ordinarily present when a private key is stored in a single place.

Digital assets advance not only the manner in which assets may be held, but also the manner in which assets may be used. Digital assets can be used in connection with novel investment mechanisms that utilize "smart contracts"—software code stored on the blockchain that contains automated rules for what will happen to digital assets sent or stored in that smart contract depending on other events or conditions. Each smart contract is assigned a public address that takes the form of a series of numbers and letters, with which any user can interact. Because the rules are built directly into the computer code, use of smart contracts eliminates the need for intermediaries to execute instructions as to how a particular asset should be used, transferred, or held. Investors are therefore able to perform actions with their digital assets more efficiently and at a lower cost since using intermediaries is not necessary.

Blockchain technology affords investors unique opportunities to maximize returns in ways that are not possible with traditional asset class investments. For instance, the proof-of-stake consensus mechanism allows for investors to earn rewards on their digital assets by contributing to the security of the blockchain network. This may involve an investor staking (or "locking") his or her digital assets in a protocol that uses smart contracts to govern the rules and instructions applied to this mechanism (i.e., determining the rewards, length of locking period, ability of returning the assets, etc.).[3] Digital assets can also be used in connection with smart contracts to

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[3] See Vitalik Buterin, Why Proof of Stake? (Nov. 6, 2020), available at https://vitalik.ca/general/2020/11/06/pos2020.html; see also Cong T. Nguyen et al., Proof-of-Stake Consensus Mechanisms for Future Blockchain Networks: Fundamentals, Applications and Opportunities, Digital Object Identifier 10.1109/ACCESS.2019.2925010 (June 26, 2019).

control and effect transfers of digital assets pursuant to predefined parameters, whether that may be a trade, purchase, or sale upon predetermined conditions.[4] Some smart contracts make up "decentralized applications" ("dapps").[5] A wide variety of dapps require users to lock digital assets within a smart contract or protocol to earn additional digital assets, qualify for certain benefits, or engage in transactions. Dapps contain code that governs the actions taken on the locked assets, which may be distributed to other users, destroyed or returned to the user based on preprogrammed parameters.[6]

Given the technological advancements associated with digital assets, many U.S. investors already seek to access this asset class through their relationships with registered investment advisers. The Association believes that the SEC, in formulating any final rule, should continue to allow investors to access this asset class by accommodating the unique features and functionalities of digital assets, rather than treat them as subject to the identical framework applicable to traditional asset classes.

II. The Proposed Rule Contravenes the Advisers Act by Significantly Curtailing Digital Asset Investment Activity.

The Proposed Rule represents an unjustified expansion of the SEC's authority under the Advisers Act and improperly deviates from the SEC's position of neutrality on the merits of investments. The Proposed Rule expands the reach of the Custody Rule, which currently applies only to "funds and securities," to cover all "assets," including digital assets that may not be able to be custodied in compliance with the Proposed Rule. The inclusion of digital assets in the proposed definition of "assets" would represent an unjustified expansion of the SEC's jurisdiction to regulate non-security digital assets under the Dodd-Frank Act. Further, if the Proposed Rule were adopted in its current form, registered investment advisers would be required to maintain client assets, including digital assets, with a qualified custodian that has possession or control of such assets at all times in which the investment adviser has custody. This requirement would significantly curtail registered investment advisers from making certain digital asset investments and engaging in certain digital asset activities on behalf of their clients, without regard to clients' individual investment objectives, tolerance for risk, or agreed-upon asset allocation in contravention of the Advisers Act's foundational principles. In addition, this restriction would "deviate[] from the Commission's long-standing position of neutrality on the merits of investments" and would act to substitute the professional judgment of investment advisers for that of the SEC.[7]

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[4] See Jake Frankenfield, What Are Smart Contracts on the Blockchain and How They Work (Feb. 9, 2023), available at https://www.investopedia.com/terms/s/smart-contracts.asp.

[5] See Joseph O'Neill, Matt Hussey and Scott Chipolina, What are Decentralized Apps (Dapps)? (Apr. 29, 2022), available at https://decrypt.co/resources/what-are-decentralized-applications-dapps.

[6] Id.; see also Blocknative, A Staker's Guide to Ethereum Slashing & Other Penalties (Oct. 1, 2022), available at https://www.blocknative.com/blog/an-ethereum-stakers-guide-to-slashing-other-penalties.

[7] 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.

A. By Covering All "Assets," the Proposed Rule Exceeds the Authority Granted to the SEC by Congress in the Dodd-Frank Act's Amendments to the Advisers Act.

The SEC purports to derive its authority to regulate all "assets," including digital assets, from Section 223 of the Advisers Act, as amended by the Dodd-Frank Act. However, the legislative history of the Dodd-Frank Act indicates that Congress did not intend to expand the actual types of assets subject to the Custody Rule or that the SEC was granted newfound authority with respect to regulation of custodial practices. Rather, the legislative history suggests that Congress's authority over client assets and custodial practices remained unchanged in the wake of the Dodd-Frank Act.

The Dodd-Frank Act amendments to the Advisers Act provide in relevant part that "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."[8] While Congress made numerous directives to the SEC under the Dodd-Frank Act to improve the regulation of the financial markets, this language does not indicate a clear mandate to the SEC to promulgate rules and regulations regarding custody of advisory client assets. By contrast, in other sections of the statute, Congress's express directive to the SEC was clear. In Section 761(b) of the Dodd-Frank Act, for example, Congress instructs the SEC:

> by rule, [to] further define (1) the term 'commercial risk'; (2) any other term included in an amendment to the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) made by this subtitle; and (3) the terms 'security-based swap,' 'security-based swap dealer,' 'major security-based swap participant,' and 'eligible contract participant.'[9]

Similarly, Section 413(b)(1)(B) of the Dodd-Frank Act directs the SEC to redefine the term "accredited investor . . . by notice and comment rulemaking."[10] By contrast, in Section 223, Congress noted that the SEC may prescribe rules to enable investment advisers to do so.[11] Indeed, a congressional research report noted that the SEC may decide to issue new rules regarding custody of client assets, but that such rules may be "the same as, or similar to, rules that the agency would have issued even if the Dodd-Frank Act had not been enacted."[12]

Nor is there any indication in the legislative history that Congress specifically sought for the SEC to expand the actual types of assets subject to the Custody Rule. The use of the term "assets" rather than "funds or securities" in the statute was not discussed in any official Senate or House

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[8] See 15 U.S.C. § 80b-18b (emphasis added).

[9] 15 U.S.C. § 78c(a).

[10] See Congressional Research Service, Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 4 (Nov. 3, 2010), available at https://www.llsdc.org/assets/DoddFrankdocs/crs-r41472.pdf.

[11] See 15 U.S.C. § 80b-23.

[12] Congressional Research Service, Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act, 5 (Nov. 3, 2010) (noting that "the agency's rulemaking authority in this area has not changed").

report or hearing.[13] The official Senate report echoes the sentiments expressed in the legislative history of the passing of the Advisers Act in 1940. Both histories merely reflect a focus on preventing fraud and misappropriation and enhancing custodial protections to reduce the risk of theft by bad actors.

Had Congress intended for the SEC to expand the scope of assets within its jurisdiction, such an intent would have been specifically reflected in the legislative history. In the absence of such a mandate, the SEC may not interpret Section 223 to include a directive to regulate all assets, regardless of their character. And the SEC's prior actions reflect an understanding of the limits of its rulemaking authority in this area. For example, in 2010, the SEC recognized in the adopting release for amendments to the Custody Rule that the use of the term client "assets" did not represent an expansion of regulatory authority, but rather, was used "solely for ease of reference."[14]

In asserting that the use of the term "assets" in Section 223 grants it the authority to regulate non-security digital assets (and other types of non-traditional assets), the SEC impermissibly seeks to expand its jurisdiction without any basis in law. Indeed, while the SEC has broad jurisdiction to regulate securities, it generally does not have the authority to regulate non-security assets, such as commodity futures, without express congressional authority. For example, the Dodd-Frank Act granted shared authority to the SEC and the Commodity Futures Trading Commission to regulate "mixed swaps."[15] Without such a clear grant of congressional authority, the SEC may not attempt to sweep all digital assets within its jurisdiction. As noted below, whether a particular digital asset meets the definition of a security is a complex facts and circumstances analysis and conducting that analysis is required to determine whether the SEC has jurisdiction over a particular asset in the absence of a broader congressional mandate.

B. The Proposed Rule Is Inconsistent with the Principles-Based Regime Established Under the Advisers Act.

By significantly curtailing an investment adviser's ability to invest in digital assets, the Proposed Rule is inconsistent with the regulatory framework established by Congress under the Advisers Act. The Advisers Act grants investment advisers broad discretion in carrying out their fiduciary obligations, subject only to the limits of anti-fraud prohibitions and the scope of the contractual rights and obligations to which advisers and their clients agree.[16] In contrast to the prophylactic, rules-based approach to the regulation of investment companies taken by Congress in the

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13 S. Rep. No. 111-176, 76-77 (2010).

14 Custody of Funds or Securities of Clients by Investment Advisers, Release No. IA-2968, 75 FR 1456, 1456 n.2 (Jan. 11, 2010).

15 17 C.F.R. § 1.9.

16 When Congress enacted the Advisers Act, it granted the SEC the authority to promulgate rules and regulations designed to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business. 15 U.S.C. § 80b-6(4); see also H. R. Rep. No. 2639, 76th Cong., 3d Sess. 28 (1940) ("The essential purpose of title II of the bill is to protect the public from the frauds and misrepresentations of unscrupulous tipsters and touts and to safeguard the honest investment adviser against the stigma of the activities of these individuals by making fraudulent practices by investment advisers unlawful."); see also S. Rep. No. 111-176, 76-77 (2010) (noting the legislation sought to reduce the risks of Ponzi schemes and theft by requiring client assets to be maintained with qualified custodians).

Investment Company Act of 1940, the Advisers Act does not aim to regulate the types of investments or assets that investment advisers recommend to their clients.[17] Instead, Congress "recognize[d] the personalized character of the services of investment advisers and especial care [was] taken in the drafting of the bill to respect this relationship between investment advisers and their clients."[18]

Supreme Court precedent and recent SEC interpretive releases only serve to underscore Congress's legislative mission. In SEC v. Capital Gains Research Bureau, Inc., the Supreme Court observed that the Advisers Act "reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate or at least expose, all conflicts which might incline an investment adviser . . . to render advice which was not disinterested."[19] And in a seminal 2019 release, the SEC observed that an investment adviser's fiduciary obligation affords discretion in making determinations about the suitability of investments to align with clients' investment objectives. Thus, the SEC noted that an investment adviser's "specific obligations [] flow from the adviser's fiduciary duty [and] depend upon what functions the adviser, as agent, has agreed to assume for the client, its principal."[20] The SEC went on to state that "[t]he fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent."[21]

As further detailed below, if adopted in its current form, 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. Prohibiting these actions makes it impossible for investment advisers to conduct key investment activities involving digital assets and thus unlawfully curtails their ability to provide services related to digital assets—an entire class of investments—even if investing in digital assets aligns with an adviser's fiduciary duties.

In particular, the Proposed Rule's possession or control requirements improperly limit an investment adviser's ability to custody client assets in accordance with its fiduciary duty obligations. The Proposed Rule would require registered investment advisers to maintain client digital assets with a qualified custodian that has possession or control of such assets at all times

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[17] See, e.g., 15 U.S.C. § 80a-19 ("It shall be unlawful for any registered investment company to pay any dividend, or to make any distribution in the nature of a dividend payment, wholly or partly from any source other than— (1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or (2) such company's net income so determined for the current or preceding fiscal year. . .").

[18] See H. R. Rep. No. 2639, 76th Cong., 3d Sess. 28 (1940); see also S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).

[19] 375 U.S. 180, 192 (1963) (citing 2 Loss, Securities Regulation, 1412 (2d ed. 1961) (internal quotations omitted)).

[20] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, Fed. Reg. No. 2019-12208 (July 12, 2019).

[21] Id.

in which the registered investment adviser has custody.[22] This conflicts with the Advisers Act's mandated fiduciary duty obligations — a duty of care and a duty of loyalty.[23] This fiduciary duty requires, among other things, investment advisers to "adopt the principal's goals, objectives or ends."[24]

Under the Proposed Rule's possession or control requirement, registered investment advisers would not be able to carry out their fiduciary duties because they could not engage with blockchain networks in accordance with their client's investment objectives. For example, certain investment activities involving digital assets require the assets to be controlled or accessed by smart contracts. In particular, despite a lack of safety and security concerns, registered investment advisers would not be able to stake digital assets on certain blockchains and use digital assets within certain dapps to the extent that the digital assets would be controlled by the relevant blockchain or smart contract and therefore not within a qualified custodian's possession or control.[25]

Moreover, due to the unique technology required to safely custody digital assets, an investment adviser's fiduciary duty obligations may require the adviser to self-custody certain client assets. The Proposed Rule's possession or control requirements would prohibit an adviser from self-custodying client assets even if self-custody is the safest, most secure method of custody.

Registered investment advisers should be able to engage in such practices, including the self-custody of digital assets, to meet their client's goals so long as the adviser can satisfy itself that the client's digital assets are protected from the risk of loss through the secure protocols that distributed ledger technology affords. The fatal limitations of the Proposed Rule would prevent a registered investment adviser from carrying out its fiduciary duties under the Advisers Act. The Proposed Rule would thus ultimately eliminate the ability of advisory clients to take advantage of certain digital asset investment products in a safe and well-regulated manner.

C. The Proposed Rule Would Improperly Inhibit Advisers' Ability to Transact Through Digital Asset Exchanges.

In addition, under the Proposed Rule, advisers would be prohibited from trading on digital asset exchanges that are themselves not qualified custodians because the exchange would hold custody of the asset even if only for a brief moment in time. Most exchanges require pre-funding a trade of digital assets, which requires the assets to be traded to first be placed on the exchange

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[22] "Possession or control" would mean holding assets insofar as: (1) the qualified custodian is required to participate in any change in beneficial ownership of those assets; (2) the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership; and (3) the qualified custodian's involvement is a condition precedent to the change in beneficial ownership. See Proposed Rule 223-1(a)(1)(i) and (d)(2)(8).

[23] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, Fed. Reg. No. 2019-12208 (July 12, 2019).

[24] Id.

[25] For example, a registered investment adviser that chooses to stake ether on the Ethereum blockchain must lock the ether within the Ethereum blockchain deposit contract. Staked ether may be programmatically destroyed in the event that the adviser does not operate its validator node in accordance with the network's rules (e.g., makes an incorrect attestation) and can only be unstaked in accordance with the requirements of the network.

before the trade goes through. However, few custodial trading platforms meet the definition of qualified custodian; rather, most exchanges operate in a bifurcated manner in which an exchange offers trade execution services and an affiliated entity that may be a qualified custodian offers custodial services. While the custodian affiliate may be able to meet the segregation and accounting requirements under the Proposed Rule, exchanges would not.[26]

Exchanges, particularly those with affiliated custodians, have developed their own security protocols that are specifically designed for digital assets, and these protocols may be more effective at safeguarding client assets than those designed for traditional asset classes. In addition, because complying with the Proposed Rule would be unduly burdensome, it would be extremely difficult for an exchange to make the necessary changes required to also meet the definition of a qualified custodian.

As a result, advisers would thus be limited to purchasing and selling digital assets over-the-counter ("OTC"), or on non-custodial exchanges, which do not maintain custody of the assets traded. Although advisers may choose to use OTC or non-custodial exchanges in certain circumstances, the Proposed Rule should not constrain advisers' ability to determine the most appropriate trading venues to purchase and sell client assets. A prohibition against utilizing custodial trading platforms that are not qualified custodians could prohibit registered investment advisers from accessing the largest liquidity pools and run contrary to the policy goals underlying an adviser's duty of best execution.[27] Limiting an adviser's trading to OTC markets and certain non-custodial exchanges could also make those markets more susceptible to volatility.

Rather than adopt the Proposed Rule in its current form, the SEC could allow alternative arrangements that provide equal or better protections. For example, the SEC could permit advisers to utilize trading platforms that are affiliated with qualified custodians, subject to certain heightened controls. Separately, in addition to mandating an internal control report, the Proposed Rule could require qualified custodians with affiliated exchange platforms to undergo more frequent surprise examinations, periodic independent cybersecurity audits, and periodic SEC reporting obligations concerning risk assessments, incident responses, and remediation.

Instead, the Proposed Rule runs roughshod over the foundational principles underlying the Advisers Act by usurping the role played by investment advisers and their clients in making determinations about the suitability of investments by effectively prohibiting: (i) self-custody of assets that cannot be reduced to traditional forms of custody; (ii) participation in non-custodial distributed ledger activities, like staking, that require assets to be deposited in blockchain-based

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[26] Release at 67 ("Because we understand that most [digital] assets, including [digital] asset securities, trade on platforms that are not qualified custodians, this practice would generally result in an adviser with custody of a [digital] asset security being in violation of the current custody rule because custody of the [digital] asset security would not be maintained by a qualified custodian from the time the [digital] asset security was moved to the trading platform through the settlement of the trade. In light of our proposal to expand the rule's application from "funds or securities" to "assets," this practice would also constitute a violation of the proposed rule for an adviser with custody of client [digital] assets if the adviser trades those assets on a [digital] asset trading platform that does not satisfy the definition of 'qualified custodian.'").

[27] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, Fed. Reg. No. 2019-12208 (July 12, 2019) ("An investment adviser's duty of care includes a duty to seek best execution of a client's transactions . . .").

smart contracts not administered by a central intermediary; and (iii) transactions on digital asset exchanges that are themselves non-qualified custodians. Such a result would conflict with the freedom investors enjoy to make their own investment decisions and to shape their advisory relationships as they see fit and would represent a departure from the SEC's statutory mandate (and established practice) to remain impartial on the merits of particular investments or asset classes.[28] Nowhere in SEC guidance or the SEC's interpretation of advisers' fiduciary duty to clients is there a suggestion that certain investments are off-limits, but that is exactly what the Proposed Rule would effectively do.[29]

These effective prohibitions could result in registered investment advisers ceasing to provide digital asset advisory services to clients that have specifically sought those services.[30] In the words of Commissioner Uyeda, the Proposed Rule "appears to mask a policy decision to block access to [digital] assets as an asset class. It deviates from the Commission's long-standing position of neutrality on the merits of investments."[31] Such a veiled attempt to eradicate digital assets as an asset class exceeds the bounds of the principles-based framework of the Advisers Act.

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[28] To the extent that the SEC has concerns about the risks associated with particular asset classes, those concerns can be addressed by advisers through disclosure and conformance to the duty of care. That is the regulatory approach that is required under the Advisers Act and is the approach that the SEC and its staff have always taken with respect to non-traditional assets. See, e.g., Risk Alert, Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021), available at https://www.sec.gov/files/digital-assets-risk-alert.pdf; see also SEC 2023 Examinations Priorities (Feb. 7, 2023), available at https://www.sec.gov/files/2023-exam-priorities.pdf.

[29] See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248, Fed. Reg. No. 2019-12208 (July 12, 2019) ("An investment adviser must have a reasonable belief that the advice it provides is in the best interest of the client based on the client's objectives. The formation of a reasonable belief would involve considering, for example, whether investments are recommended only to those clients who can and are willing to tolerate the risks of those investments and for whom the potential benefits may justify the risks . . . [w]hen an adviser is assessing whether high risk products—such as penny stocks or other thinly-traded securities—are in a retail client's best interest, the adviser should generally apply heightened scrutiny to whether such investments fall within the retail client's risk tolerance and objectives [and determine the extent to which] such products are in the best interest of a retail client initially, they would require daily monitoring by the adviser.").

[30] See Release at n.478 ("To the extent these pooled investment vehicles hold [digital] assets that may be outside of the current rule's scope (i.e., they are neither funds nor securities), those assets would be within the scope of the proposed rule. To the extent that it becomes cost-prohibitive for advisers to find a qualified custodian, or otherwise comply with the proposed rule with respect to these newly covered [digital] assets, we believe that advisers may choose to cease providing advisory services to pooled investment vehicles holding such assets, implying these pooled investment vehicles may no longer be offered to investors.").

[31] 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.

III. The Proposed Rule's Qualified Custodian Requirements Will Reduce Protections for Advisory Clients that Invest in Digital Assets.

The Proposed Rule's qualified custodian requirements will dissuade digital asset-native custodians from continuing to provide custodial services, which will reduce, rather than increase, protections for advisory clients. In addition, the Proposed Rule's segregation requirement, as applied to state chartered banks, would impose a regulatory regime that rests on ambiguous state law principles and thus would not permit advisers to know with certainty whether they are complying or even can comply with the Proposed Rule.

A. The Requirements Imposed on Qualified Custodians Will Limit Custodial Options.

Like the Custody Rule, the definition of "qualified custodian" under the Proposed Rule would include several enumerated types of financial institutions, including a "bank" as defined in Section 202(a)(2) of the Advisers Act.[32] Section 202(a)(2) of the Advisers Act in relevant part defines a "bank" to mean:

> a trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted by 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.[33]

While the Proposed Rule did not modify the ability of state-chartered financial institutions to serve as qualified custodians, the Release questions whether recent entrants to the market for digital asset custodial services, such as state-chartered trust companies, are "regulated to provide [ ] the types of protections [the SEC believes] a qualified custodian should provide under the rule."[34] As Commissioner Uyeda noted, the SEC's dim view of the quality of regulatory protection and oversight imposed on such institutions inappropriately implies that "state regulated banking entities are less trustworthy than federally chartered ones."[35] We agree with Commissioner Uyeda. The definition of "bank" under the Advisers Act, as applied to state-chartered institutions, does not include subjective standards regarding technological controls or the merits of a particular state's regulatory regime. Any interpretation to the contrary raises serious federalism issues that are beyond the limits of the SEC's constrained rulemaking authority. The SEC should make clear that the Proposed Rule is not intended to categorically prohibit state banking organizations from qualifying as qualified custodians.

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[32] 17 C.F.R. § 275.206(4)-2(d)(6).

[33] 15 U.S. Code § 80b–2(a)(2).

[34] Release at 75–76.

[35] 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.

State-chartered limited purpose trust companies and special purpose depository institutions, which have developed cutting-edge digital asset custodial technologies, can and do serve as qualified custodians. But the question that arises under the Proposed Rule is whether they will want to continue to do so. The Proposed Rule would require a registered investment adviser with custody of client assets to enter into a written agreement with and obtain assurances in writing from a qualified custodian to ensure the qualified custodian provides certain custodial protections when maintaining client assets.[36]

Certain of these requirements may be unworkable for digital asset custodians. For example, the requirement that a custodian indemnify clients against losses caused by the custodian's simple negligence is a drastic departure from market practice and would be cost-prohibitive for many custodians that operate on slim profit margins. Nowhere does the SEC explain the basis for ratcheting up the standard of care applicable to custodians through regulatory fiat, rather than allowing custodians and their customers to negotiate the scope of liability coverage as has been done for decades.

The indemnification requirement would also require the qualified custodian to have insurance arrangements in place to adequately protect the client from the custodian's simple negligence.[37] Our members' experience is that obtaining such insurance coverage in the current environment is commercially challenging because most insurers are unwilling to insure the loss of digital assets caused by simple negligence, and those insurers that are willing to do so may only underwrite policies at cost-prohibitive rates.

Moreover, the Release provides no indication of specific requirements to obtain such insurance and no economic impact analysis on the industry, leaving market participants little insight into the particular obligations the SEC may be seeking to impose on them under the Proposed Rule.[38] As discussed below, the SEC's failure to adequately consider the economic impact of the indemnification and insurance requirements makes the Proposed Rule subject to challenge as arbitrary and capricious. Yet as the SEC acknowledges, these requirements are likely to result in a reduction in the number of firms willing to serve as qualified custodians as well as substantial

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[36] See Release at 74. These include assurances that the custodian will: (1) exercise due care in accordance with reasonable commercial standards in discharging its duty as custodian and implement appropriate measures to safeguard client assets from theft, misuse, misappropriation, or other similar type of loss; (2) indemnify the client against losses caused by the qualified custodian's negligence, recklessness, or willful misconduct; (3) not be excused from its obligations to the client as a result of any sub-custodial or other similar arrangements; (4) clearly identify and segregate client assets from the custodian's assets and liabilities; and (5) not subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client. See Release at 22–23.

[37] Release at 86.

[38] Id.

increased costs to advisers and custodians that will ultimately be passed on to investors.[39] The Proposed Rule would thus act to benefit large financial institutions while inhibiting competition and capital formation—two aims of both the Biden administration and the SEC under Chair Gensler's leadership.[40]

But most fundamentally, to the extent that the Proposed Rule encourages digital asset-native qualified custodians to exit the business, the Proposed Rule would have a direct and adverse impact on advisory clients – the very constituents that the rule is designed to protect. And, the SEC, as it must, concedes this point:

> [T]o the extent advisers have custody of client [digital] assets that are not funds or securities and those assets are maintained with state-chartered trust companies, other state-chartered, limited purpose banking entities, and entities providing platform users with the ability to transact in [digital] assets who may choose not to make the changes necessary to satisfy all of the requirements to act as a qualified custodian under the [Proposed Rule], the [Proposed Rule] would require such [digital] assets to be removed from those entities. Removing assets from those entities could create costs for investors. For example, there would be costs associated with switching from one entity to another. As we noted in section II.C.3, the technical requirements for transacting and safeguarding [digital] assets are likely to differ from those of traditional assets that include stocks, bonds, and options. *The [P]roposed [R]ule could cause investors to remove their assets from an entity that has developed innovative safeguarding procedures*

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[39] See Release at 272 n.479 ("To the extent competition in the market for those aspects of services that gives advisers custody is linked to the number of advisers offering such services, advisers choosing to eliminate the aspect of their services that gives them custody could result in a reduction in competition. A reduction in competition could result in higher fees for investors, lower quality services, or some combination of the two."). The Proposed Rule is the latest indication that the SEC seeks to inhibit the growth of a new [digital asset] economy. While casting doubt on the ability of state-chartered institutions to safely custody digital assets, the Proposed Rule highlights a joint statement by federal banking regulators warning regulated banking organizations of the "safety and soundness concerns" with business models that have concentrated exposure to digital assets or that are concentrated in digital asset activities. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023).

[40] For example, President Biden stated, "I expect the federal agencies — and they know this — to help restore competition so that we have lower prices, higher wages, more money, more options, and more convenience for the American people." Remarks by President Biden At Signing of An Executive Order Promoting Competition in the American Economy (July 9, 2021); see also Chair Gary Gensler, "Competition and the Two SECs," Remarks Before the SIFMA Annual Meeting (Oct. 24, 2022) ("Competition increases returns for investors and lowers the cost of capital for issuers. It promotes innovation and efficiency in the middle of the markets. It helps capital markets more effectively price and allocate money and risk. It helps the U.S. maintain our global competitiveness.").

> *for those assets, possibly putting those assets at a greater risk of loss.*[41]

At this point, digital asset-native custodians lead the industry in developing technological solutions to custody many digital assets in the safest way possible. We fear advisers may be forced to move assets away from these digital asset-native custodians toward traditional financial services institutions who have not yet developed comparable technological solutions. This shift would leave clients' assets vulnerable. Advisory clients' digital assets would be exposed to a greater risk of misappropriation, theft or loss, by causing the concentration of such assets with a smaller number of qualified custodians.

In addition, concentration of custodial services among a small number of institutions would heighten systemic risk considerations because any failure of a single custodian or exchange could impact large swaths of the marketplace. Of course, our concerns assume that traditional financial institutions will step in to fill the void left in the event that digital asset-native custodians exit the business. But that itself is an assumption that is far from certain in the wake of Staff Accounting Bulletin 121, which requires reporting entities engaging in digital asset custodial activities to record a liability with a corresponding asset on their balance sheet for all digital assets held in custody, among other requirements.[42] Staff Accounting Bulletin 121 acts to discourage traditional financial institutions from entering the digital asset custodial space and risks further limiting (and isolating) advisers and their clients from custodial options in the event that the Proposed Rule were adopted.

Nonetheless, putting out of business entities that have dedicated substantial resources to effectively secure digital asset custodial services and harming investors who most need protection contravenes the SEC's threefold mission to protect investors, maintain fair, orderly, and efficient markets and facilitate capital formation, and would exceed the SEC's authority under the Advisers Act to regulate registered investment advisers – and by extension – activities undertaken on behalf of their clients in an impartial manner.

B. The Segregation Requirement Imposed on State-Chartered Banks Depends on Application of Ambiguous State Law Principles.

The Proposed Rule's segregation requirement, as applied to state-chartered banks, would impose a regulatory regime requiring the application of ambiguous state law principles. The Proposed Rule would require a qualified custodian that is a bank or a savings association (i.e., a state-chartered trust company or special depository institution) to hold client assets "in an

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[41] Id. at 272–73 (emphasis added); see also id. at 76 ("[W]e understand that some existing qualified custodians have modified their practices to remain profitable amid these changes, such as by contractually limiting their liability to their customers in a variety of ways. Others have turned to outsourcing less profitable parts of their custodial services. Our staff has observed that the clients who are least likely to have bargaining power are often afforded the fewest protections. These changes in the custodial industry have caused us to reconsider the minimum protections we believe an adviser who uses a qualified custodian to maintain possession or control of client assets should provide.").

[42] See SEC Staff Accounting Bulletin No. 121, 87 Fed. Reg. 21,015 (Apr. 11, 2022).

account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association."[43]

The Release states that this requirement is designed to prevent misuse or appropriation of client assets and provide protection from general creditors in the event of such an insolvency or failure.[44] The Release states that the benefit of this requirement "would be limited to the clients of those qualified custodians that would not be subject to the resolution processes deployed by the [Federal Deposit Insurance Corporation ("FDIC")] or by the OCC or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers."[45]

Under state law, however, client assets that are distinguishable from a bank's general assets and revert to the customer outside a bank's insolvency must be held in a "special account" (or as a "special deposit") that may not be established automatically.[46] Instead, the requirements for establishing a special account vary by state and are largely subjective. For example, some courts have held that claimants seeking special account treatment "must clearly show the parties' intent to establish a special account to overcome the presumption" that such assets are no more than general bank assets.[47] Indeed, courts have stated that demonstrating the requisite intent of the parties is a "heavy" and "difficult" burden of proof, and although no particular wording is required to evidence such intent, there must be clear evidence of a "trust relationship, or an intent to

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[43] See Release at 44 (". . . the rule would require that a qualifying bank or savings association hold client assets in an account that is designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association (i.e., an account in which client assets are easily identifiable and clearly segregated from the bank's assets) in order to qualify as a qualified custodian.").

[44] Release at 164, 278.

[45] See Release at 278 ("We believe that requiring banks and savings associations to hold client assets in an account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association would benefit clients by providing client assets with enhanced protection from general creditors in the event of the qualified custodian's insolvency or failure and increasing the likelihood of return of client assets to advisory clients upon a qualified custodian's insolvency or failure. We acknowledge, however, that the benefit would be limited to the clients of those qualified custodians that would not be subject to the resolution processes deployed by the [FDIC] or by the OCC or have not developed and deployed comprehensive custodial service agreements governing their relationships with their custodial customers.").

[46] A special account or "special deposit" is a species of custody account which becomes such by agreement to create a trust. "To create such a deposit, the bank must be made an agent or trustee, and agency or trusteeship cannot be created out of the mere external relationship of debtor and creditor unless the deposit is wrongful or the law forbids the bank becoming a debtor. . . . A special deposit is sometimes said to be equivalent to a bailment, but it is not always of that order. . . . Special or specific deposits are of a trust nature, and the relationship between the depositor and the bank is that of principal and agent or bailor and bailee." Michie on Banks and Banking § 339 (2011).

[47] Edward H. Klees, How Safe Are Institutional Assets in a Custodial Bank's Insolvency, 68 Bus. Law. 103, 113 (2012) ("Because special accounts enjoy such extraordinary treatment, courts typically presume that all bank deposits are general assets and so a claimant must clearly show the parties' intent to establish a special account in order to overcome the presumption.").

segregate the assets for the client's benefit."[48] Further, merely establishing an account called a "special account" or "custody account" does not mean that a court will respect its designation as a special account. To the contrary, the numerous state court opinions on this issue confirm that customer assets in putative-special deposit accounts are nonetheless routinely subject to creditor claims and other litigation.

The Proposed Rule does not adequately account for the possibility that requiring custodians to segregate client assets may not be sufficient to establish a special account that would provide protection in the event of insolvency or bank failure. While establishing a special account may be one element in establishing a "trust relationship," additional clear evidence would likely be required to demonstrate a custodian's intent to segregate the assets for the client's benefit. Furthermore, state law is not static; standards for establishing a special deposit can evolve over time and can be revisited by courts and legislatures at their discretion. Because there is no clear legal standard governing what is required to protect client assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank or savings association, the Proposed Rule sets out an impossible standard.

The Proposed Rule should instead allow for the flexibility that is currently provided to advisers in assuring their clients' assets remain safe in the event of insolvency or bank failure. If adopted as proposed, the Proposed Rule would depend on the application of ambiguous state law principles and would not achieve its objective of protecting client assets from an insolvency or failure event.

IV. The Proposed Rule Exceeds the SEC's Regulatory Authority under the APA.

When Congress enacted the Advisers Act, it granted the SEC authority to promulgate rules and regulations to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business.[49] While such mandate was broad, it did not give the SEC unlimited authority to regulate the conduct of investment advisers. The Proposed Rule's significant curtailment of an adviser's ability to engage in digital asset investment activities contravenes 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."[50]

A. The Proposed Rule Violates the Major Questions Doctrine.

In West Virginia v. EPA, the Supreme Court held that an agency violates this mandate under the APA when it attempts to assert regulatory authority over major political and economic questions without clear permission from Congress.[51] The Supreme Court reasoned that the Environmental Protection Agency ("EPA") exceeded its regulatory authority under the Clean Air Act when, without a legislative mandate, it attempted to limit emissions at power plants by shifting power generation sources to those with less polluting qualities.[52]

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[48] See Seattle-First v. Nat'l Bank v. FDIC, 619 F. Supp. 1351, 1360 (W.D. Okla. 1985); Swan Brewery Co. v. U.S. Trust Co., 832 F. Supp. 714, 718 (S.D.N.Y. 1993); Goldblatt v. FDIC, 105 F.3d 1325, 1329 (9th Cir. 1997).

[49] 15 U.S.C. § 80b-6(4).

[50] 5 U.S.C. § 706(2)(A), (C)–(D).

[51] 142 S. Ct. 2587, 213 L. Ed. 29 896 (2022).

[52] Id.

West Virginia rests on two key principles of the major questions doctrine under the APA. First, the Court noted that agencies must have clear authority to decide major questions affecting large swaths of the population because "Congress intends to make major policy decisions itself."[53] Further, because Congress does not delegate major lawmaking authority to the executive branch lightly, there must be a "clear congressional authorization" to resolve such questions of major economic and political significance.[54] The SEC's approach to regulating digital assets as outlined in the Proposed Rule is indistinguishable from the EPA's attempt to regulate greenhouse gas emissions and is impermissible under the APA.

Like the regulation at issue in West Virginia, the Proposed Rule would have wide-ranging implications for millions of Americans. A recent survey indicated that 20 percent of Americans, which would constitute over 50 million people, own digital assets.[55] The survey also estimated that the total value of all digital assets combined is $804 billion.[56] Custody of digital assets raises novel and complex issues that could have significant implications for these millions of Americans, the broader financial industry, and the economy as a whole.

Further, in numerous instances, Congress has made clear that it intends to make policy decisions regarding digital assets and custody of digital assets itself. In recent years, Congress has considered numerous bills addressing the status of digital assets within the regulatory framework and the roles of regulatory bodies in governing digital asset activities.[57] For example, last year, the Digital Asset Market Structure and Investor Protection Act was introduced to address the regulatory treatment of digital assets and digital asset securities, including the obligations of digital asset service providers to meet customer protection and account custody requirements.[58]

Congress has also expressed that it intends to resolve the major questions facing the digital asset industry more broadly. For example, in a hearing before the House Financial Services Committee on April 18, 2023, Congresswoman Ann Wagner noted that the SEC has continuously acted without congressional authorization in promulgating 53 proposed rules in the first 18

[53] Id.

[54] Id.

[55] 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); Bankrate, Cryptocurrency statistics 2023: Investing in crypto (Jan. 5, 2023).

[56] Id.

[57] 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.

[58] Digital Asset Market Structure and Investor Protection Act, 117 H.R. 4741 (2021–2022) (ordering the Secretary of the Treasury to enact rules requiring digital asset service providers to meet certain requirements, including using registered and qualified custodians, proper customer account labeling and identification, minimum of quarterly account statements being issued to customers by the registered and qualified custodian, annual surprise audit requirements and annual audits by accounting firms which are registered with the Public Company Accounting Oversight Board).

months of the Gensler administration, while other congressmen noted that the approach to the Proposed Rule here is no exception to that pattern.[59]

Because Congress has signaled that it, and not the SEC, is the appropriate body to decide how the digital asset industry should be regulated, the SEC has exceeded its authority under the Advisers Act in violation of the APA.

B. The SEC's Cost-Benefit Analysis Is Insufficient.

Moreover, courts have recognized that "the Commission has a unique obligation to consider the effect of a new rule upon 'efficiency, competition, and capital formation,' . . . and its failure to 'apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation' makes promulgation of the rule arbitrary and capricious and not in accordance with law."[60] 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."[61] The burden is higher for "significant regulatory action," which is defined in part as "any regulatory action that is likely to result in a rule that may . . . [h]ave an annual effect on the economy of $100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local, or tribal governments or communities," as well as rules that may "[r]aise novel legal or policy issues."[62]

The economic analysis in the Release notes that the expanded scope of the rule's applicability (covering all "assets," rather than "funds and securities") and the new requirements applicable to qualified custodians, particularly the requirements to enter into written agreements and obtain reasonable assurances would impose high costs on market participants. Notwithstanding the mere acknowledgement that such requirements would impose costs, the SEC failed to account for just how costly they would be and in doing so, disregarded its obligation to consider the effects of the Proposed Rule on competition and capital formation.

For example, the Release contains no analysis of the cost to obtain written agreements between qualified custodians and investment advisers. Nor does the Release account for the prohibitive cost imposed on either qualified custodians or investment advisers to obtain insurance sufficient

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[59] House Financial Services Committee, Hearing on the Oversight of the Securities and Exchange Commission (Apr. 18, 2023), available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408690.

[60] Business Roundtable v. SEC, 647 F.3d 1144, 1148 (2011) (striking down an SEC rule that would have made it easier for shareholders to nominate directors to corporate boards because the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters."); see also American Equity Investment Life Insurance Company v. SEC, 613 F.3d 166, 167–68, 392 U.S. App. D.C. 1 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 412 F.3d 133, 143, 366 U.S. App. D.C. 351 (D.C. Cir. 2005) (same).

[61] Exec. Order No. 12,866, 3 C.F.R. 638 (1993).

[62] Id.

to indemnify against the loss of client assets due to simple negligence. In addition, the Release inadequately assesses the impracticality of the requirement for a qualified custodian to obtain a written internal control report that includes an opinion of an independent public accountant. On that point, the Release does not consider the current environment digital asset investors and custodians are operating in: due to the lack of regulatory clarity in the digital asset industry, there are virtually no independent public accountants that will provide such opinions or assurances. Given the impossibility of compliance, the cost of compliance with the Proposed Rule far exceeds its benefits. Because the SEC neglected its duty to determine the likely economic consequences of the Proposed Rule, the Proposed Rule is subject to challenge as arbitrary and capricious under the APA.

C. The SEC's Statement in the Release Concerning the Current Treatment of Digital Assets under the Federal Securities Laws Contravenes the APA.

The SEC's sweeping assertion in the Release that "most [digital] assets are likely to be funds or digital asset securities covered by the current rule" has far-reaching and immediate consequences for market participants, yet the SEC failed to provide an adequate explanation for its view, as is required under the APA.[63] If challenged in litigation, we believe the SEC's statement would be struck down as an arbitrary and capricious regulatory action.

The SEC has, since 2017, indicated that the Supreme Court's test for whether an instrument is an "investment contract," as set forth in SEC v. Howey, will generally control when evaluating the status of a given digital asset as a "security."[64] The "Howey test" calls for an assessment of the facts and circumstances unique to each digital asset, which, by design, makes it difficult to determine, with certainty, whether a given digital asset is or is not a security in the absence of a judicial decree.[65] Other parts of the definition of security, such as "notes" or "transferable shares," can also apply to digital assets that are not investment contracts and similarly are grounded in facts and circumstances legal analyses that cannot be applied uniformly.[66]

Although the SEC acknowledges in a footnote of the Release the heft of the analytical framework that governs, the SEC confoundingly sidesteps the test in its entirety and states with a sweeping

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[63] See Proposing Release at 18. As Commissioner Peirce noted in her statement with respect to the SEC's characterization of most digital assets as securities, such "sweeping statements in a rule Release seem designed for immediate effect, a function proposing releases should not play. These statements encourage investment advisers to back away immediately from advising their clients with respect to [digital assets and] seem to be part of a broader strategy of wishing complete jurisdiction over [digital assets] into existence." 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.

[64] See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf. See SEC v. Howey, 328 U.S. 293 (1946).

[65] See SEC Framework for "Investment Contract" Analysis of Digital Assets (describing how the SEC analyzes whether a digital asset is an investment contract, and therefore, a security, under the Howey test), available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[66] See, e.g., Reves v. Ernst & Young, 494 U.S. 56 (1990).

hand its view that "most [digital] assets are likely to be funds or securities." The agency's approach to regulating digital asset markets through staff interpretations and enforcement actions, rather than notice and comment rulemaking, led one market participant to submit a formal petition for rulemaking.[67] After nearly 10 months without a response, the market participant filed a lawsuit against the Commission in an attempt to compel it to provide an answer.[68] We believe the language in the Release is yet another attempt by the agency to evade its obligation to provide a reasoned analysis supporting its view that many, if not all, digital assets are securities.

This statement amounts to a rule under the APA because it seeks to establish a standard of conduct for market participants with the force of law.[69] Unlike a policy statement, which announces an agency's tentative intentions for the future, the statement in the Release establishes a binding norm as a rule does.[70] Under the APA, rules are required to undergo a notice and comment period to collect input from affected parties. Indeed, "[a]gencies have never been able to avoid notice and comment simply by mislabeling their substantive pronouncements. On the contrary, courts have long looked to the contents of the agency's action, not the agency's self-serving label, when deciding whether statutory notice-and-comment demands apply."[71]

The statement in the Release thus violates the APA because it affords market participants no opportunity to participate in the administrative process and voice their concerns.[72] Further, while agencies are free to change their prior positions, they must provide a reasoned basis for doing so.[73] The SEC has not attempted to provide an explanation for its conclusion that most digital assets are funds or securities without conducting an analysis of the facts and circumstances. The

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[67] See Coinbase Petition for Rulemaking – Digital Asset Securities Regulation (July 21, 2022), available at https://www.sec.gov/rules/petitions/2022/petn4-789.pdf.

[68] See In Re Coinbase, Inc.'s Petition for Writ of Mandamus to the SEC (Apr. 24, 2023), available at https://cryptopotato.com/coinbase-compels-sec-to-respond-to-rulemaking-petition-in-new-lawsuit/.

[69] 5 U.S.C. § 551(4) expansively defines a rule as "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements" of the agency. Interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice are not considered to be rules for purposes of the APA. 5 U.S.C. § 553(b)(A).

[70] See Pacific Gas & Elec. Co. v. FEC, 506 F.2d 33, 38 (1974) ("A properly adopted substantive rule establishes a standard of conduct which has the force of law . . . [a] general statement of policy, on the other hand, does not establish a 'binding norm.' . . . A policy statement announces the agency's tentative intentions for the future."); see also Guardian Fed. Sav. & Loan Assn. v. Federal Sav. & Loan Ins. Corp., 589 F.2d 658, 666–67, 191 U.S. App. D.C. 135 (CADC 1978) (if "a so-called policy statement is in purpose or likely effect . . . a binding rule of substantive law," it "will be taken for what it is.").

[71] Azar v. Allina Health Servs., 139 S. Ct. 1804, 1812 (2019).

[72] 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.").

[73] See, e.g., 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.").

sweeping statement lacks legal analysis and fails to provide a reasoned basis for the SEC's change in its approach towards regulating digital assets. The statement thus suffers from fatal defects as arbitrary and capricious under the APA and should be rescinded.

V. The Proposed Rule Fails to Adequately Account for Distinctive Digital Asset Features and Would Leave Investors' Assets More at Risk.

As noted above, digital assets are unlike any other asset class and should be available to investors through their registered investment advisers. The failure of the Proposed Rule to address the unique technological aspects of digital assets is particularly disappointing given the vast knowledge and technical expertise that the SEC and its staff have apparently developed in this area.

The SEC staff has acknowledged that the unique properties of digital assets could pose challenges for advisers seeking to custody digital asset securities in compliance with the Custody Rule. For example, the Division of Investment Management acknowledged in a 2019 request for public comment that "characteristics particular to digital assets [could] affect compliance with the Custody Rule."[74] In addition, in 2020, the Division solicited further input on "whether there are qualities that would be important for safeguarding digital assets that might not be important for safeguarding other types of assets."[75]

In response, custodians and other market participants submitted numerous comments noting key developments in digital asset custodial practices and highlighting challenges presented by the Custody Rule. For example, commenters noted that "standardized market conventions and policies have not yet developed for custodians' handling of forks and airdrops or of in-kind distributions and contributions, the lack of which can contribute to uncertainty and risk."[76] Because of these novel characteristics, commenters recommended that the staff permit registered investment advisers to self-custody digital assets in circumstances where the adviser

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[74] SEC, Staff Letter, Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019), available at https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206.

[75] SEC Staff Statement on "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; see also Securities Exchange Act Release No. 34-90788 ("The technical requirements for transacting and custodying digital asset securities are different from those involving traditional securities . . . traditional 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."), available at https://www.sec.gov/rules/policy/2020/34-90788.pdf.

[76] Letter from Polychain Capital LP re Custody Rule and Digital Assets (Apr. 13, 2021), available at https://www.sec.gov/files/polychain-capital-lp-071619.pdf; see also Letter from Anchorage re Custody Rule and Digital Assets (Apr. 13, 2021) (noting that "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."), available at https://www.sec.gov/files/anchorage-041321.pdf. The other comments received in response to the Staff Statement are available at https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets.

appropriately determined that a third-party custodian would not better serve the interests of its advisory clients, subject to certain conditions.[77]

Yet the Proposed Rule fails to consider these important comments. Contrary to the Proposed Rule's stated purpose of safeguarding client assets, it threatens to put advisory clients' assets at a greater risk of loss or misappropriation. As noted, the inability to self-custody in particular would leave registered investment advisers with no secure custody options if, for example, there are no qualified custodians with adequate technology to custody a given digital asset or type of digital asset.

Moreover, technology exists to custody digital assets in an even safer manner than physical or more traditional assets. The use of MPC technology in particular provides for a safer means of custody of digital assets by "sharding" or breaking up cryptographic keys into fragments and distributing them for secure processing. When successfully implemented, MPC-based custodial arrangements enhance (rather than diminish) customer digital asset security by reducing private key misappropriation as a potential risk factor, despite the fact that MPC technology does not require intermediation by traditional financial institutions or other third parties. But, because of the possession and control requirements in the Proposed Rule, it is unclear whether using MPC technology would be permitted.

By not being permitted to use technological advancements in asset security, investment advisers will be forced to use less safe measures of custodying their clients' assets, which also may contravene an adviser's fiduciary duty obligations. For these reasons, among others, if the SEC adopts the Proposed Rule in its current form, it would limit advisers' custodial options, resulting in less, *not more*, protection for advisory clients, who remain the primary beneficiaries of the Custody Rule.

Further, while the Proposed Rule makes no accommodation for the unique technological features of digital assets, it explicitly acknowledges that private securities and physical commodities merit special consideration because they have atypical features. For example, the Proposed Rule notes that physical assets are sometimes unable to be maintained by qualified custodians or that qualified custodians may refuse to custody such assets "because the inherent physical characteristics of the items increase the expenses associated with their maintenance and safekeeping."[78]

In recognition of these issues, the Proposed Rule includes an exception to the requirement that a registered investment adviser maintain client assets with a qualified custodian if the adviser has custody of client private securities or physical assets, provided that the adviser meets certain conditions, including that the adviser reasonably safeguards the assets from loss, theft, misuse,

[77] Release at 78.
[78] Release at 127.

misappropriation, or the adviser's financial reverses.[79] We believe that the SEC should include within the Proposed Rule exclusions and accommodations to address the unique features of digital assets, just as the SEC has done for privately offered securities and physical assets.

Indeed, we are not aware of any colorable policy justification for the SEC's apparently intentional decision not to expand the exception available for private securities and physical assets to include digital assets.[80] Like physical assets and unlike most traditional securities, digital assets are capable of being used and consumed within a broad variety of outlets for various purposes (e.g., as stake on a proof-of-stake blockchain or to pay "gas" fees required to execute a transaction). In addition, both physical assets and digital assets are "one-of-a-kind" assets that cannot be reduced to traditional forms of custody. This should be recognized in the Proposed Rule.

The SEC claims that "the asset-neutral approach of the [Custody Rule] has been and will continue to be more effective because it relies on the expertise of the various types of qualified custodians and allows the rule to remain evergreen as the types of assets held by custodians evolve."[81] However, contrary to the SEC's stated commitment to an asset-neutral approach, by failing to

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79 See Proposed Rule 223-1(b)(2). The exception is permitted if a registered investment adviser meets the following conditions: (i) the registered investment adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control transfers of the beneficial ownership of such assets; (ii) the registered investment adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency; (iii) an independent public accountant, pursuant to a written agreement between the adviser and the accountant (a) verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and (b) notifies the Commission's Division of Examinations within one business day upon finding any material; (iv) the adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day; and (v) the existence and ownership of each of the client's privately offered securities or physical assets that are not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit during the course of performing its procedures.

80 See Release at 272–73 ("The expanded scope of assets subject to the proposed rule could create costs for those advisers (and their clients) with custody of [digital] assets that are not funds or securities subject to the current custody rule. For example, to the extent advisers have custody of client [digital] assets that are not funds or securities and those assets are maintained with state-chartered trust companies, other state-chartered, limited purpose banking entities, and entities providing platform users with the ability to transact in [digital] assets who may choose not to make the changes necessary to satisfy all of the requirements to act as a qualified custodian under the proposed rule, the proposed rule would require such [digital] assets to be removed from those entities. Removing assets from those entities could create costs for investors. For example, there would be costs associated with switching from one entity to another. . . The proposed rule could cause 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.").

81 Release at 78.

address the unique features of digital assets, the Proposed Rule unfairly acts to limit registered investment advisers from investing in the asset class in accordance with their fiduciary duties and their clients' objectives.

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The Association encourages the SEC to provide transparent regulatory oversight of the digital asset industry by revising 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,

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