By Electronic Submission and Email

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 205499-1090

Re: Safeguarding Advisory Client Assets
File Number S7-04-23

Dear Ms. Countryman:

The Crypto Council for Innovation (CCI)\(^1\) appreciates the opportunity to comment on the Securities and Exchange Commission (SEC or Commission) proposal to adopt Rule 223-1 under the Investment Advisers Act of 1940 (Advisers Act) to address how investment advisers safeguard client assets.\(^2\) The proposed rule (the Safeguarding Rule), if approved, would require investment advisers registered or required to register with the Commission under the Advisers Act (RIAs) to maintain all client assets, including crypto assets with a qualified custodian, subject to certain narrowly-defined exceptions.

In light of our mission, the feedback in this letter focuses on the real-world effects of the proposed Safeguarding Rule on RIAs and, ultimately, on advisory clients (including the many retail investors) who seek value through crypto assets. As President Biden noted recently in the Executive Order on Ensuring Responsible Development of Digital Assets, “In the absence of sufficient oversight and standards, firms providing digital asset services may provide inadequate protections for sensitive financial data, custodial and other arrangements relating to customer assets and funds, or disclosures of risks associated with investment.”\(^3\)

We encourage the SEC to carefully consider the feasibility and practical consequences of the proposed Safeguarding Rule on RIAs that invest in crypto assets and the clients in whose interest they act. We are also concerned that the Safeguarding Rule, especially as it pertains to crypto assets, appears to have been proposed without the thorough collection and examination of data relating to (i) crypto assets and their characteristic features and (ii) crypto asset custodians and their services and capabilities. Relatedly, we are concerned that RIAs who hold crypto assets for

---

\(^1\) CCI is an alliance of crypto industry leaders with a mission to communicate the opportunities presented by crypto and demonstrate its transformational promise. CCI members span the crypto ecosystem and include some of the leading global companies and investors operating in the industry. CCI members share the goal of encouraging the responsible global regulation of crypto to unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity. Achieving these goals requires informed, evidence-based policy decisions realized through collaborative engagement.

\(^2\) See Advisers Act Release No. 6240 (Feb. 15, 2023), 88 FR 14672 (Mar. 9, 2023) (the “proposal” or “Proposing Release”).

clients will find it extraordinarily difficult to implement the proposed Safeguarding Rule. Our view is based on several factors, including:

1. The absence of any informed discussion in the proposed Safeguarding Rule of the qualified custodians who serve the crypto market and the range of crypto assets for which custodial services are available. Instead, the Commission appears to proceed on the basis that qualified custodians would be available for crypto assets and that qualified custodians already serve the complete range of crypto assets RIAs hold for their clients. Both assertions are questionable. Equally questionable is the Commission’s proposed requirement that qualified custodians invariably indemnify RIA clients against the risk of loss of assets, including crypto assets. The Commission appears to have undertaken no study of whether such indemnification is feasible in the context of crypto assets and whether adequate insurance arrangements and insurers are available for crypto assets.

2. The Commission also does not appear to have considered fundamental attributes of many crypto assets, such as staking, yield, voting, or governance features, and how these features will operate while the assets are held by a qualified custodian. A similar dilemma for RIAs is posed by the Commission’s proposal to prohibit RIAs from transacting through crypto trading platforms. The absence of any discussion on how custody and trading will work in practice for crypto assets could put RIAs in the untenable position of abandoning viable and worthwhile investment strategies involving crypto assets. The Commission has not explained how effectively prohibiting crypto investment strategies protects investors. Nor has the Commission articulated any statutory basis for such prohibition. Unless Congress explicitly declares crypto assets off-limits to RIAs, the Commission should enact no such rule that operates as a complete ban on RIA investments in legitimate assets.

3. In addition to its failure to consider relevant data and its failure to consider the practical effects of the proposed Safeguarding Rule on the various types of crypto assets, the Commission appears to have ignored potential alternatives to the proposed qualified custodian requirement. Most notably, and despite its obvious benefits, the Commission fails to consider a broader self-custodial regime as a possible alternative where no adequate qualified custodian can be found. These failures — the failure to more thoroughly collect and review relevant data, the failure to consider the feasibility of the proposed requirements, and the failure to consider adequate alternatives — mean that the proposal fails to satisfy the obligations to which the Commission is subject under the Administrative Procedure Act (APA), and the Advisers Act.

Before the Commission adopts the Safeguarding Rule in its proposed form, CCI requests that the Commission take the additional steps outlined below. In the absence of such further Commission action, the proposed Safeguarding Rule would fail in its stated aims of strengthening and clarifying existing custody protections. Even more significantly, the Commission’s failure to take such further action would cause widespread confusion for RIAs and other crypto asset market participants and would frustrate the Commission’s tripartite mission of protecting investors; maintaining fair, orderly, and efficient markets; and facilitating capital formation.

1. The Commission should collect data on and evaluate:
A. The availability of qualified custodians for crypto assets, especially early-stage token projects, and the range of crypto assets served by such qualified custodians.

B. The range of crypto assets with staking, yield, governance, or other participatory features, and how these features will or will not work while these assets are maintained with a qualified custodian.

C. Custodial arrangements at crypto trading platforms, the actual risks of loss at such platforms, how platforms guard against such loss, and the availability of trading alternatives to crypto trading platforms.

D. Insurance and indemnification arrangements available with respect to crypto assets – in particular, the extent and availability of such arrangements for crypto asset custodians, and the number and type of assets for which arrangements are available.

The Commission should then review the workability of the proposed Safeguarding Rule in light of the data collected and its evaluation of such data. In particular, the Commission should consider, in light of the data collected, whether:

- RIAs holding crypto assets for clients can reasonably identify and engage qualified custodians for the full range of crypto assets they hold or seek to hold;
- The proposed Safeguarding Rule would result in the concentration of crypto assets with a few qualified custodians, and the risks of such concentration;
- RIAs holding client crypto assets can reasonably deploy crypto assets to make use of standard asset features, such as staking, voting, or other governance functions;
- RIAs holding crypto assets for clients can reasonably access adequate venues for the trading of crypto assets; and
- Qualified custodians holding crypto assets for RIAs can reasonably provide the indemnification proposed under the Safeguarding Rule.

2. If, after its consideration of the relevant data, the Commission concludes that the proposed Safeguarding Rule cannot be reasonably operationalized by RIAs on any one or more of the above parameters, the Commission should withdraw the existing proposal and repurpose it to meet its statutory requirements under the APA and the Advisers Act. This would enable the Commission to give RIAs the necessary opportunity to provide meaningful comment on the proposed Rule before it is adopted.

3. In repurposing the Safeguarding Rule, the Commission should consider an expanded and robust exemption from the qualified custodian requirement that permits RIAs to self-custody crypto assets where qualified custodians are unavailable, subject to additional safeguards to be maintained by RIAs, as further discussed below.

4. In its review of the proposed Safeguarding Rule, the Commission should consider whether proposing requirements that RIAs cannot reasonably meet in the context of crypto assets
may cause investors who seek value through such crypto assets to migrate to unregulated investment advisers and the systemic and other risks posed by such migration.

These, and other requests and concerns are discussed in greater detail below. We welcome the opportunity to engage with the Commission and Staff to address our concerns and develop regulations and solutions together, in line with these requests.

* * *

I. Significantly More Data and Analysis are Required to Determine Whether and How the Proposed Safeguarding Rule Should Reasonably Apply to RIAs Holding Crypto Assets.

When the Commission proposes, amends, or adopts a new rule pursuant to congressionally delegated authority, the APA requires the Commission to provide the public with a meaningful opportunity to comment on the rule’s content.\(^4\) Section 202(c) of the Advisers Act requires the Commission, when it is engaged in rulemaking pursuant to the Act, to consider or determine whether an action is necessary or appropriate in the public interest and to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.\(^5\)

These statutory mandates are supported by a number of judicial precedents that recognize the Commission’s “statutory obligation to determine as best it can the economic implications of the rule.”\(^6\) Also notably, the Commission’s own Office of General Counsel recognizes that “the basic elements of a good regulatory economic analysis” include:

- the definition of a baseline against which to measure the likely economic consequences of the proposed regulation;
- the identification of alternative regulatory approaches; and
- an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis.\(^7\)

Despite these express statutory and judicial requirements, and seemingly contrary to its own stated best practices, the Commission inexplicably fails to consider in adequate detail the economic implications of the proposed Safeguarding Rule as they relate to crypto assets markets. The Commission’s failure to collect and analyze several critically important items of crypto asset data

\(^4\) 5 U.S.C. § 553.
results in the absence of a baseline against which to measure the likely economic consequences of the proposed Safeguarding Rule.

We discuss further below some of the prominent areas where the Commission has failed to compile essential data regarding the proposal's impact on crypto asset market participants. The absence of this data causes the Commission to breach its own best practices on rulemaking — but more importantly, it prevents the Commission from putting forward an adequately researched proposal, well-supported by data and analysis for public review and comment. These failures breach the Commission’s APA and Advisers Act obligations.

A. The Proposal Fails to Adequately Survey the Availability of Qualified Custodians for Crypto Assets and the Range of Crypto Assets Served by Such Custodians.

In the Proposing Release, the Commission notes that it has analyzed the extent to which RIAs offer various kinds of services related to crypto assets.\(^8\) It also observes that “[t]he market for crypto asset custodial services continues to develop” and that one national bank regulated by the Office of the Comptroller of Currency (OCC), four OCC-regulated trust banks, approximately 20 state-chartered trust companies and limited purpose banking entities, and at least one Futures Commission Merchant currently offer custodial services for crypto assets.\(^9\) However, the Commission provides no further detail on the crypto custodial services purportedly provided by these entities. The Commission omits even the most cursory examination of the crypto assets that these custodial entities support.

After stating that RIAs offer various services related to crypto assets, the Commission makes no attempt to examine whether there is any correlation between the types of crypto assets for which RIAs offer services and the crypto assets for which custodial services are available. The Commission even notes “that many advisers may be reluctant to provide a full range of advisory services to their clients with respect to crypto assets because of concerns that a market for custodial services to safeguard these assets has not yet fully developed.”\(^10\) However, the Commission undertakes no evaluation of whether and how the proposed Safeguarding Rule might decrease the number of qualified custodians who service crypto assets, thereby increasing RIAs’ reluctance to provide a full range of advisory services with respect to crypto assets.

Despite stating its belief, unsupported by any data, that “[t]he market for crypto asset custodial services continues to develop,” the Commission fails to acknowledge several data points that appear to contradict this observation. For example, the Proposing Release does not expressly note that there are currently no special purpose broker-dealers capable of custodying crypto asset securities — a fact that the Commission has acknowledged elsewhere,\(^11\) but which is surely of great

---

\(^8\) Proposing Release at 14739.

\(^9\) Id. at 14740.

\(^10\) Id. at 14691.

\(^11\) See Exchange Act Release No. 96496 (Dec. 14, 2022), 88 FR 5440, 5448 (Jan. 27, 2022), noting that “only a small portion of crypto asset security trading activity is occurring within entities that are registered with the Commission and any of the [Self-Regulatory Organizations]. For example, there are currently no special purpose broker-dealers authorized to maintain custody of crypto asset securities.”
relevance to the workability of the Safeguarding Rule. The proposal does not consider the increasing restrictions placed by federal banking regulators on banks engaging in crypto asset activities, and the impact this may have on the availability of banks as qualified custodians for crypto assets. The Proposing Release states, without further identification, that there are four OCC-regulated trusts that offer crypto custodial services but fails to note that the conditional national trust banking charter granted to one of these four entities has expired without it receiving permanent approval.

Beyond a single unsupported sentence in the Proposing Release, the Commission appears to have made no effort to verify whether the handful of custodians currently offering crypto assets are currently operational, and to what extent, and whether they actually support the crypto assets that RIAs hold for their clients. Under the APA, the Commission must “articulate a satisfactory explanation for its action including a rational connection between the facts found and the choices made.” Here, however, the Commission has found practically no facts on the nature of the market for custody of crypto assets and has consequently performed no meaningful evaluation of whether the crypto asset custodial options available are adequate for RIAs to meaningfully comply with the proposed Safeguarding Rule.

The Commission asks whether the Safeguarding Rule should permit only banks or savings associations that are subject to Federal regulation and supervision to act as qualified custodians. We strongly disagree – investors in crypto assets need more custodial options, not less, and the state-chartered trusts have played, as the Commission acknowledges, a vital role in supplementing the often-meager crypto custodial options available. However, in order to determine whether more or fewer institutions should be eligible qualified custodians for crypto assets, an

12 See, for example, Joint Statement on Crypto-Asset Risks to Banking Organizations issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, (Jan 3, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf (noting that “the agencies have significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector”); Policy Statement on Section 9(13) of the Federal Reserve Act (Jan. 27, 2023) 88 FR 7848 (Feb. 7, 2023); “Federal Reserve Board announces denial of application by Custodia Bank, Inc. to become a member of the Federal Reserve System” (Press Release, Jan. 27, 2023) available at https://www.federalreserve.gov/newsevents/pressreleases/orders20230127a.htm.


15 We would also note here the comments of Prof. Adam Levitin on the Safeguarding Rule. Prof Levitin notes that the drafting of the proposed definition of “qualified custodian” is unclear. That definition refers to “(i) A bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b-2(a)(2)) or a savings association as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)) that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act (12 U.S.C. 1811)…” Prof Levitin notes that it is unclear whether the “that has deposits insured by the FDIC” clause modifies both the term “a bank” as well as the term “a savings association” or only “a savings association.” He takes the view, and we strongly agree, that the clause should modify both banks and savings associations as there is no reason to treat banks differently than savings associations in this regard. See https://www.sec.gov/comments/s7-04-23/s70423-20163827-333933.pdf.

16 Proposing Release at 14742 (noting that “...the staff has observed a growing number of state-chartered trust companies and other state-chartered, limited purpose banking entities now offering custodial services for crypto assets.”)
essential first step must be to assess what custodial options currently exist. Nothing in the Proposing Release suggests that the Commission has made this vital finding, and this conspicuous omission raises concerns as to whether the Commission is adhering to its statutory obligations under the APA.


Many crypto assets feature important economic or governance rights, which may require temporarily moving crypto assets out of a custodian’s control in order to exercise those rights. For example, many crypto assets are capable of being “staked,” which involves committing the crypto assets in order to validate transactions on their underlying protocol. Stakers temporarily deposit tokens, and a transparent, immutable algorithm determines which stakers get to perform some action, e.g., verify transactions and win rewards for doing so. The holder of the staked crypto assets may be temporarily deprived of their use until the staking process is completed. For certain protocols, if misconduct occurs during transaction validation, the staker may lose a portion of its stake (so-called “slashing”).

Other crypto assets may feature similar economic opportunities – such as “yield farming,” in which users’ crypto assets are “locked-up” in protocols to earn a yield. As with staking, yield farming may involve temporarily removing a crypto asset from a custodian’s control in order to earn income. Crypto assets may also feature important governance rights, such as the right to exercise one’s vote in connection with a crypto asset. Similar to the right to vote with traditional securities on corporate actions, crypto assets often grant the holder the right to vote on protocol development. In many instances, exercising an economic or governance right related to a crypto asset may require shifting the control of the asset from the custodian to an unaffiliated third-party program.

These economic and governance features of crypto assets may place RIAs seeking to comply with the proposed Safeguarding Rule in an impossible conundrum. On the one hand, the proposed Safeguarding Rule would require an RIA to maintain its crypto assets with a qualified custodian at all times and would permit no exception for the exercise of rights associated with such assets. On the other hand, an RIA is a fiduciary, and as part of its fiduciary duty, an RIA must always serve the best interest of its client and not subordinate its client’s interest to its own. In 2019, the

---

17 By one count, there are more than 450,000 tokens on the Ethereum blockchain alone, which may have one or more of such economic or governance features. See ERC-20 Tokens: What They Are and How They Are Used (Feb. 22, 2023), available at https://bitpay.com/blog/erc-20-tokens-what-they-are-and-how-they-are-used#:~:text=The%20established%20guidelines,Shiba%20Inu%20Coin%20(SHIB).


21 Walker & Maitra, Crypto Asset Custody.


23 Id. at 33675.
Commission noted that an investment adviser must consider “an investment product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client.”24 If the Safeguarding Rule is adopted as proposed, RIAs that may otherwise have held crypto assets with economic or governance rights for their investors will find themselves either effectively prohibited by the Rule from transacting in such assets or forced to absolutely deny investors the benefit of the economic or governance rights associated with such assets, potentially even against their investors’ best interests. In effect, the Commission has proposed a complete bar on RIAs holding crypto assets with economic or governance rights without duly reviewing the considerable adverse economic implications that would flow from this prohibition.

The Safeguarding Rule and the Proposing Release do not appear to have considered the dilemma for RIAs posed by crypto assets with economic and governance features. The Proposing Release is entirely silent on staking, yield farming, voting, or any feature of crypto assets that might require them to be periodically moved out of custody. Given the proliferation and popularity of such crypto assets, this omission is puzzling — either the Commission is worryingly unfamiliar with the basic features of many of the crypto assets that it proposes to subject to the Safeguarding Rule, or the Commission inexplicably does not consider the problem posed for RIAs and the clients they serve to be worth addressing. To be sure, the Commission need not address every conceivable question engendered by a rulemaking, but this question — of how an RIA can productively put client crypto assets to use while simultaneously complying with the Safeguarding Rule — is integral to the operation of the proposed rule. Where the Commission “entirely [fails] to consider an important aspect of the problem,”25 it likely acts arbitrarily and capriciously, and thus in violation of the APA.

C. The Proposal Fails to Consider the Economic Implications of Preventing RIAs From Trading on Crypto Asset Platforms.

In the Proposing Release, the Commission notes that most crypto assets, including crypto asset securities, trade on platforms that are not qualified custodians. The Commission concludes that such trading would generally result in an RIA with custody of a crypto asset security violating the current custody rule because custody of the crypto asset security would not be maintained by a qualified custodian from the time the crypto asset security was moved to the trading platform through the settlement of the trade.

The Commission asks how the proposed Safeguarding Rule would impact advisers who currently trade on such trading platforms,26 but the Commission makes no attempt to conduct even a preliminary assessment of the likely impact. In fact, the impact on RIAs who transact in crypto, and on their clients, is likely to be considerable and adverse. A more nuanced approach by the Commission to on-platform crypto trading could easily minimize such adverse impact.

24 Id. at 33674 (emphasis added).
26 Id.
If the Commission’s effective prohibition on the trading of crypto assets on platforms that are not qualified custodians is adopted, the immediate effect could be to significantly narrow the range of trading venues available to RIAs and deprive them (and their clients) of the deepest, most liquid markets for crypto assets. Left without access to some of the largest crypto asset trading venues, RIAs would likely have to pay significantly higher fees for crypto asset trades with market makers — fees that would ultimately be borne by RIA clients, to their detriment. RIAs with larger trading volumes and those capable of executing larger trades may retain some negotiating power vis-à-vis market makers, but smaller RIAs and their clients will likely be disproportionately adversely affected — an outcome that should give the Commission pause.

Less obvious, but even more significant than these adverse consequences, is the proposed prohibition’s relationship with RIAs’ fiduciary duties. According to the Commission, an RIA’s duty of care to its clients includes the duty to seek the best execution of a client’s transactions. This duty of best execution requires an adviser to seek to obtain the execution of transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances. An adviser fulfills this duty by seeking to obtain the execution of securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. For an adviser, the determinative factor for best execution is “whether the transaction represents the best qualitative execution.” If the Safeguarding Rule’s proposed prohibition on trading crypto assets on platforms is adopted, RIAs will face profound confusion as to whether to seek optimal transaction value for their clients or to maintain custody in accordance with the Rule, irrespective of the economic cost to clients. The Commission must be clear about its policy choices: is safeguarding client assets in strict conformity with the Rule more important than optimal transaction execution in all circumstances? We do not presume to advise the Commission on which policy outcome should govern, but we, like many other market participants, look to the Commission to acknowledge the problem, analyze its implications, and provide us with a thorough and well-reasoned outcome.

The Commission can avoid the confusion and undesirable consequences engendered by this proposed trading prohibition through some relatively minor exceptions to the Safeguarding Rule. For instance, the Commission could instead require that RIAs only transfer crypto assets to trading platforms on an intra-day basis and further require that such platforms to which assets are moved must maintain certain custodial safeguards, such as insurance arrangements and operational safeguards, such as multi-signature mechanisms and cold storage. In its current form, the proposal provides no such exception, even for well-established crypto trading platforms with a range of custodial safeguards in place.

27 Release No. 5248 at 33672.
28 Release No. 5248 at 33675 (emphasis added).
29 Id.
30 Id.
31 Unlike traditional financial and other assets, most crypto assets can be transparently and consistently tracked through their underlying blockchain, thereby reducing the need for an audit. Thus, although the Safeguarding Rule would require qualified custodians to have an independent public account verify the client assets held by the custodian (see proposed Rule 223-1(a)(4)), this independent verification requirement is much less likely to be a concern for crypto assets, particularly those crypto assets on public permissionless blockchains, whose existence can be verified at all relevant times.
The Commission should also consider the difference between centralized and decentralized crypto trading platforms – a distinction on which it has sought information, but not otherwise discussed in the Proposing Release. While the Commission views with concern the fact that trading on a centralized platform requires moving the crypto asset to the platform through the settlement of the trade, these concerns may be misplaced in the context of a decentralized trading platform or a decentralized exchange. Decentralized exchanges, also known as DEXs, are peer-to-peer marketplaces where crypto asset traders transact directly without handing over the management of their funds to an intermediary or custodian. These transactions are facilitated through the use of smart contracts, i.e., self-executing agreements written in code. DEXs allow users to trade directly from their wallets by interacting with the smart contracts behind the trading platform. Traders guard their funds and are responsible for losing them if they make mistakes such as losing their private keys or sending funds to the wrong addresses. The Commission should therefore recognize the fact that DEXs do not take charge of users’ crypto assets at any point in the transaction and should accordingly carve DEXs out of the general prohibition on RIAs trading crypto assets on platforms.

The Commission makes no attempt to examine the technological differences underlying the different types of crypto trading platforms. Instead, the Commission proposes to impose a blanket ban on platform-based crypto asset trading by RIAs and proposes to do so without even undertaking a cost-benefit analysis for this prohibition. This failure to undertake even a cursory cost-benefit analysis not only goes against the Commission’s own stated best practices, it means that the Commission, acting in violation of Section 202(c) of the Advisers Act, has failed to adequately consider how the proposed prohibition affects investor protection, efficiency, competition, and capital formation.

D. The Proposal Fails to Adequately Consider Whether Crypto Asset Custodians Can Provide the Indemnities Required under the Proposed Safeguarding Rule.

The Proposing Release would require RIAs to obtain reasonable assurances from qualified custodians that, among other things, the custodian would indemnify RIA clients against losses caused by the qualified custodian’s negligence, recklessness, or willful misconduct. On its face, this seems a reasonable assurance provided by qualified custodians with respect to many traditional assets. But the Commission never inquires, much less determines, whether custodians are likely to be able to provide such assurance with respect to crypto assets. The Proposing Release notes that the Commission has “observed that the contractual limitations on custodial liability vary widely in the marketplace, in some instances reducing a qualified custodian’s liability to such an extent as to not provide an appropriate level of investor protection.” However, there is no discussion at any level of detail regarding the reasons for such variance or whether adequate insurance arrangements exist across the range of crypto assets.

32 Proposing Release at 14690.
34 Id.
35 OGC Memorandum at 3, noting that “as SEC chairmen have informed Congress since at least the early 1980s—and as rulemaking releases since that time reflect—the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules.”
36 Proposing Release at 14745.
The Commission notes that even with respect to the custody of traditional assets, the proposed indemnification requirement “would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients by preventing these custodians from disclaiming liability for misconduct that does not rise to the level of gross negligence.” If this requirement is a “substantial expansion” for custodians of traditional assets, it may well be an infeasible requirement for custodians of crypto assets, given the nascent insurance markets for crypto assets. Insurance coverage for crypto assets is expensive and often simply unavailable. In what is becoming a vicious circle, the uncertain regulatory environment for crypto assets deters many insurers from providing adequate coverage.

The Commission appears to acknowledge that this and other requirements may be infeasible, admitting that, “To the extent an element is not typical for a particular custodian, it may create practical difficulties (e.g., higher costs of compliance, or market contraction for custodial services).” Yet, the Commission goes on to conclusorily state that “On balance, however, we believe the proposed rule promotes key protections to which every custodial customer should be entitled when the adviser has custody.” Also notably, the Commission perceptively observes that “the negotiating power of the investor appears to play an outsized role in the type of misconduct for which a custodian will provide indemnity and that retail investors appear to have limited ability to negotiate these terms effectively.” Yet the Commission makes no exception for RIAs with limited negotiating ability, requiring all RIAs, regardless of size and negotiating power, to obtain exactly the same assurances from the small number of firms that provide custodial services for crypto assets. Predictably, the smallest RIAs and their clients will be most disadvantaged by the proposal – a fact the Commission openly acknowledges but seemingly refuses to address.

Unlike in the case of the prohibition on RIAs trading crypto assets on-platform, the Commission has undertaken a cost-benefit analysis of the indemnity requirement. The analysis is a superficial one, however, and makes no distinction between how the requirement will affect smaller RIAs, as opposed to larger ones with greater negotiating power. The Commission makes no attempt to determine whether the indemnification requirement may further thin out the already minuscule number of qualified custodians who serve the crypto asset markets, thus resulting in the unhealthy concentration of a large number of crypto assets with a small number of qualified custodians. The Commission does not consider whether, if RIAs who are unable to obtain the required indemnities exit the crypto asset markets, investors may seek to transfer their crypto holdings to advisers unregulated by the Commission — an outcome that will likely involve significant risks to investor protection and to stable and orderly markets.

The Commission makes no attempt to consider the impact and efficacy of even the most reasonable limitations or exceptions to the indemnification requirement – such as, for example, asking RIAs to evaluate reasonably available alternatives where no qualified custodian is ready to provide the required indemnification. The Commission’s conclusory assertion of costs and benefits, unsupported by any empirical data, does not meet the Advisers Act’s requirement that it

37 Id (emphasis added).
39 Id.
40 Proposing Release at 14694.
41 Id. at 14745-46.
meaningfully evaluate how the proposed indemnification requirement affects investor protection, efficiency, competition, and capital formation.

E. The Proposal Completely Fails to Consider Reasonable Alternatives, Including a More Robust Self-Custody Regime.

A review of the proposed Safeguarding Rule, as applied to crypto assets, suggests an unclear landscape with a small but uncertain number of crypto asset custodians, with whom RIAs must at all times maintain their crypto assets. The number of qualified custodians providing services for crypto assets is narrowed further still through the proposed requirement of an indemnity against the risk of loss, an indemnity that few qualified custodians are likely to be able to provide. The requirement to maintain crypto assets with this very small number of qualified custodians is subject to no exceptions – even where the result is to deprive asset holders of all productive use of such crypto assets because they cannot effectively be staked, voted upon, or used for the other purposes for which these assets were designed. An RIA, deprived of all ability to use its clients’ crypto assets productively, cannot even seek to dispose of these assets for a competitive price through a trading platform. These restrictions, onerous in the extreme, may lead to justifiable speculation as to whether the Commission’s unstated aim is to discourage RIAs from transacting in crypto assets altogether.

Fortunately, a relatively small number of adjustments could make the proposal more workable for RIAs and qualified custodians in the crypto asset space. Most importantly, the Commission should consider expanding the exception that permits RIAs to self-custody assets, including crypto assets, under certain limited circumstances. The proposal currently permits self-custody only if certain conditions are met, including that the RIA determines in writing that the asset cannot be custodied by a qualified custodian. However, the proposed Safeguarding Rule only permits RIAs to self-custody “privately-offered securities or physical assets.”

We see no reason why the self-custodial exception should be limited only to privately-offered securities or physical assets. The primary condition for applying the self-custody exception is a reasonable determination that a qualified custodian cannot maintain possession or control of the asset. We would suggest that the Commission instead expand this requirement also to apply when a qualified custodian:

- cannot maintain possession or control of the asset in a manner that reasonably permits the use of any economic or governance features or rights associated with the asset; or
- cannot reasonably provide one or more of the assurances that the Rule would require.

The Commission would address several difficulties by expanding the self-custodial exception to potentially cover all types of assets, and by allowing for self-custody when qualified custodians cannot provide the required assurances or enable the rights associated with the asset to be used. An expanded self-custodial exception offsets the decrease in qualified custodians for crypto assets that the proposed indemnification requirement will inevitably cause. Such self-custody permits RIAs to

\[\text{\ldots} \]

\[\text{\ldots} \]
to comply with the Safeguarding Rule while also staking, voting on, or otherwise making productive use of crypto assets. Most importantly, an expanded self-custodial exception recognizes the very small number of qualified custodians who serve a limited number of crypto assets and provides an avenue away from concentrating large volumes of crypto assets with these few custodians.

To be clear, we agree with the Commission’s apparent view that self-custody should be the exception rather than the rule and that self-custody should be subject to robust guardrails. We agree with the Commission that RIAs self-custodying crypto assets must safeguard them from loss and the RIA’s insolvency. We support independent verifications and audits for self-custodied assets. And we agree that self-custody should be determined through a principles-based approach, which permits an RIA, acting consistently with its fiduciary obligations, to determine the specific safeguarding measures it puts in place for a specific asset.44

An expanded self-custodial exception with robust guardrails is essential to the workability of the Safeguarding Rule. The APA requires the Commission, in any rulemaking exercise, to consider alternatives to the proposed rule that are neither “frivolous nor out of bounds.”45 The Commission is required to address alternative ways of achieving its objectives and to provide adequate reasons for rejecting these alternatives.46

To be sure, the Commission is not required to consider “every alternative ... conceivable by the mind of man ... regardless of how uncommon or unknown that alternative” may be,47 but in this case, the Commission does not appear to have considered any alternatives at all to its proposal to require all assets, regardless of type, to be maintained with qualified custodians at all times, without exception. We therefore urge the Commission to remedy its earlier failure to consider alternatives by reviewing and adopting an expanded and robust self-custodial exception to the Safeguarding Rule.

II The Commission Should Withdraw the Proposed Safeguarding Rule, as It Pertains to Crypto Assets, and Repropose It in Accordance with the APA and the Advisers Act.

An essential first step towards proposing a workable custodial rule for crypto assets requires collecting the data that is conspicuously absent from the proposed Safeguarding Rule. After the Commission has collected and reviewed significantly more data around, among other things,

(i) existing custodial options for crypto assets and the development of the crypto custodial market;

(ii) the economics and mechanics of staking or other deployments of crypto assets;

(iii) the adequacy of custodial safeguards at crypto asset trading platforms; and

(iv) the availability and extent of insurance coverage for crypto assets,

44 Proposing Release at 14745.
45 Chamber of Commerce, 412 F. 3d at 144.
46 Motor Vehicle Mfrs. Ass’n, 463 U.S. at 51
47 Id. at 51.
the Commission should then determine how the proposed Safeguarding Rule’s requirements for crypto assets should be revised in light of the data collected. The Commission should then repropose the revised Safeguarding Rule to permit the public (including RIAs, custodians, trading platforms, and other crypto industry stakeholders) fair and adequate notice of a more wholly considered rulemaking and the necessary opportunity to provide meaningful comment.

CCI and its members stand ready and willing to work with the Commission towards the collection of such data and the reproposal of a more thorough, nuanced, and workable Safeguarding Rule, particularly as it pertains to crypto assets. We welcome the opportunity to engage with the Commission to develop a regulatory regime that acknowledges and reflects the many real and fundamental differences between traditional finance, on the one hand, and crypto, on the other.

*   *   *

Respectfully submitted,

/s/ Sheila Warren

Sheila Warren
Chief Executive Officer
Crypto Council for Innovation

Cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Peirce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark Uyeda, Commissioner
The Hon. Jaime Lizárraga, Commissioner
William Birdthistle, Director, Division of Investment Management
Jessica Wachter, Chief Economist and Director, Division of Economic and Risk Analysis
Megan Barbero, General Counsel, Office of the General Counsel