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March 8, 2023

Submitted electronically

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

Re: New York Department of Financial Services Comment Letter for Safeguarding Advisory Client Assets Proposed Rule [Release No. IA-6240; File No. S7-04-23; RIN 3235-AM32]

Dear Ms. Countryman:

The New York Department of Financial Services ("DFS" or the "Department") is pleased to provide the Securities and Exchange Commission ("SEC" or the "Commission") with the following comments on the Commission's proposed amendments to Rule 206(4)-2 (the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). As set forth in IAA Release No. 6240 (the "Preamble")[1], the Custody Rule is to be redesignated as Rule 223-1 and thereafter referred to as the Safeguarding Rule (the "Proposed Rule" and, together with the Preamble, the "Proposal").

DFS regulates some of the largest and most sophisticated banks in the world. Moreover, most of the leading providers of virtual currency[2] custody in the United States are regulated by the Department as limited purpose trust companies ("LPTCs") under New York's banking and virtual currency regulatory regimes. DFS, therefore, has a keen interest in any potential impacts the Proposed Rule and related amendments may have on the financial institutions it regulates.[3] As a

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[1] *Safeguarding Advisory Client Assets*, 88 Fed. Reg. 14672 (Mar. 9, 2023).
[2] Footnote 25 in the Proposal provides a definition for the term "digital asset" and further notes that, for the purposes of the Proposal, the Commission does not distinguish between the terms "digital asset" and "crypto asset." The DFS typically uses the term "virtual currency," as defined in 23 NYCRR § 200.2(p), to refer to the same category of assets. For the purposes of this comment letter, the terms "digital asset" and "virtual currency" are used interchangeably.
[3] All references to LPTC entities in this letter are to those LPTC entities engaged in virtual currency business activity (described below), unless otherwise noted. While the Department also regulates and supervises LPTCs that

result of our supervision of these entities, DFS has developed a depth of experience in supervising large banks and LPTCs as well as addressing many of the novel regulatory and supervisory issues presented by digital asset businesses.

Leveraging that expertise, DFS aims to continue partnering with federal regulators, including the Commission, to ensure that the interests of all custodial customers are meaningfully protected. And we strongly encourage other regulators seeking to regulate virtual currency entities and activities to incorporate minimum standards—including capital requirements, cybersecurity programs, anti-money laundering and anti-fraud preventions, and consumer protection—similar to those developed and implemented by the Department to oversee this high-risk space in a manner that provides much-needed baseline expectations across the United States.

1. Introduction

Under the Proposed Rule as under the current Custody Rule, all SEC-registered investment advisers would be required to maintain client assets with a qualified custodian, and the term "qualified custodian" would continue to include certain state-chartered and supervised trust companies to the extent they satisfy the Advisers Act's definition of a "bank."[4] However, the Proposed Rule would require:

(i) a bank, when acting as a qualified custodian, to hold all client assets in an account designed to protect those assets from general creditors in the event of the organization's insolvency or failure;[5] and
(ii) all qualified custodians to maintain, at all times, possession or control of the client assets with which they have been entrusted.[6]

The Proposed Rule poses challenges to the entire banking industry because the application of the asset segregation provision to deposit accounts could impact a bank's use of cash on its balance sheet, upsetting the time-tested safety and soundness measures banks have traditionally relied upon to operate. Importantly, because banks use cash to support business offerings including retail-focused products (such as deposit sweeps), a segregation requirement would impair these offerings to the detriment of consumers who would have less optionality. Moreover, the asset segregation requirement as applied to bank deposits would be disruptive and costly to existing business models, likely resulting in operational breaks and higher fees to the public.

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engage in traditional trust activities only ("traditional LPTCs"), those entities have not been approved to engage in activities related to virtual currency and so are not subject to the virtual-currency-specific requirements described in this letter.

[4] In relevant part, § 202(a)(2) of the Advisers Act provides that a "bank" includes 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 to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks or savings associations, and which is not operated for the purpose of evading the provisions of this subchapter….".

[5] Preamble at 14683, 14783; Proposed Rule 223-1(d)(10)(i).

[6] Preamble at 14689.

Likewise, we are concerned that as a practical matter the Commission's proposed "possession or control" requirement would operationally work against investor interests. Many trading platforms that are not qualified custodians require prefunding as a means of counterparty risk management. Excluding these participants from the virtual currency ecosystem could result in impairments to liquidity and portfolio values, harming investors, an unnecessary result considering that other safeguarding measures such as enhanced capital standards and private key management could equally address the investor protection purposes of the Proposed Rule.

We are, however, supportive of the customer-protection principles underlying the SEC's proposed segregation requirement for bank custodians if applied to custodians of virtual currency in a tailored fashion. Indeed, earlier this year, the Department issued its own guidance to New York-regulated virtual currency entities (as further explained below, BitLicensees and certain LPTCs, together "VCEs") that act as custodians, making clear the Department's expectations regarding the treatment of custodied customer assets. Specifically, DFS expects that custodians separately account for and segregate customer property from the proprietary corporate assets of a custodian and its affiliated entities. This segregation must be implemented both on-chain and in the custodian's internal ledger accounts. To the extent that the Commission is looking to ensure that virtual currency customers across the United States are afforded the same protections as those already assured in New York, the Department is aligned with the Commission's initiative and would be glad to share our experience as the Commission looks to develop a national framework. We note, however, that the Department is staunchly opposed to any national framework that would preclude state-chartered entities from full participation in the virtual currency economy, including continuing to act as qualified custodians.

Structure of Comment Letter

This comment letter discusses the Proposed Rule's potential impact on banks generally and then focuses in detail on the implications of its application to LPTCs. The letter opens with background information on DFS and the aspects of New York's virtual currency regulatory regime most relevant to the investor protection initiatives of the Proposed Rules before addressing certain elements of the Commission's Proposal and specific requests for comments.

We then discuss the application of the Proposed Rule on banks, highlighting that the Proposed Rule would indirectly regulate both the banking industry—already a highly regulated space—and private agreements. Then, we describe how the application of the Proposed Rule's asset segregation requirements impacts banks use of cash in its deposit accounts, thereby impairing flexibility in offering retail-focused products such as lower-risk interest-bearing instruments and requiring operational changes with costs borne by the public. We also explain how the requirements regarding mandated indemnification and insurance impose risks and increase liability, resulting in new costs that will be ultimately passed on to customers. Perhaps most importantly, considering the customer protection purposes of the asset segregation provision, we question the priority treatment of such segregation in cases of a bank failure. We then describe the disruptive effects of requiring indemnification and insurance provisions in the would-be newly mandated private agreements between qualified custodians and investment advisors and explain how curbing the ability of the parties to allocate risks and liability in contracts changes the business models and thus the fee structure of bank custodians.

Next, we turn to LPTCs. The investor-protection goal of the Proposed Rule may only be met by continuing to include state-regulated institutions in the definition of "qualified custodian." Narrowing the definition to exclude these entities would, as a practical matter, work at cross purposes to the Commission's investor protection goals because New York-chartered and supervised trust companies that provide custody services for virtual currencies are subject to intensive regulation and ongoing monitoring. Depriving existing virtual currency customers of safekeeping services provided by entities subject to a tailored and robust regime designed for virtual currency activities would run counter to the Commission's stated investor-protection objective.

New York's system of prudential regulation provides investors with more extensive protections than federal markets regulators are able to achieve, because our prudential regulatory framework applies to the entire entity rather than to certain of its activities. Where consumers face real risks as relates to custody (and virtual currency custody in particular), the Department's standards are more stringent than those required by federal regulators, including around cybersecurity, financial crimes, fraud, custodial practices, capital requirements, and consumer protections. Our standards set the bar for some of the largest financial institutions in the world, they effectively create a regulatory model for the entire marketplace.

Additionally, DFS's virtual currency regulatory framework is modeled on full-scope banking supervision, requiring companies to meet rigorous standards and withstand scrutiny by DFS staff before they are licensed or chartered. Once authorization is obtained, the Department comprehensively supervises each entity. Among other things, this supervision includes frequent meetings with the entity, ongoing monitoring, and importantly, the prior review and approval of material changes to an entity's business and activities. Our oversight is further enhanced by an examination program with broad authority to examine in direct response to market events. When warranted, DFS has taken substantial enforcement actions involving virtual currency companies with remedies focused on improving consumer protections.[7] As the first agency to develop a robust virtual currency regulatory framework, DFS is the most experienced virtual currency regulator in the United States. DFS provides a model for meaningful regulation of this industry as the parallel federal scheme continues to evolve.

Next, we discuss the appropriate role of the states in determining the asset segregation requirements of qualified custodians, as well as the status of state-chartered trust companies under Section 202(a) of the Advisers Act. The explicit language of the Advisers Act, includes state-chartered entities in the definition of "bank." Congress clearly and deliberately recognized the importance of state prudential regulators, and the congressional intent should control.

Finally, we respond to the Commission's request for comments regarding the proposed "possession or control" requirement. In particular, we outline below why the proposed

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[7] *See*, *e.g.*, *DFS Superintendent Harris Announces $30 Million Penalty on Robinhood Crypto for Significant Anti-Money Laundering, Cybersecurity & Consumer Protection Violations* (August 2, 2022), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202208021; *See also* *Superintendent Adrienne A. Harris Announces $100 Million Settlement with Coinbase, Inc. after DFS Investigation Finds Significant Failings in the Company's Compliance Program* (January 4, 2023), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202301041.

Safeguarding Rule would harm investors by impairing the ability to pre-fund trading accounts held at non-qualified custodian platforms, affecting liquidity and leading to devalued portfolios.

2. Background on DFS and its Virtual Currency Regulatory Regime

DFS was created in 2011 as a result of the merger of New York's Banking and Insurance Departments.[8] Prior to the combination, each predecessor department had separately operated since the mid-1800s, making them two of the longest-tenured regulatory authorities in the United States.[9] Indeed, New York has functioned as the leading state chartering authority since the enactment of the New York Free Banking Act of 1838 which provided the pattern for the National Bank Act in 1864. Today, the Department supervises a diverse range of more than 3,000 financial institutions, including banks and trust companies, insurance companies, and virtual currency businesses, among others.[10] Among the institutions DFS regulates are The Bank of New York Mellon—which, as the world's largest securities custodian, held more than $44 trillion in assets under custody as of December 31, 2022, —and The Depository Trust Company, which in 2021, settled 643 million securities trades valued at $152 trillion dollars.[11]

In 2015, DFS established the nation's first comprehensive virtual currency regulatory regime, adopted under the New York Financial Services Law ("NYFSL"), codified at 23 NYCRR Part 200, and commonly referred to as the "BitLicense" regulation. Under the BitLicense regulation, before a person may engage in any "virtual currency business activity,"[12] that person must obtain a BitLicense, unless a licensing exemption applies. LPTCs, as entities chartered under the New York Banking Law ("NYBL"), qualify for such an exemption, provided that they have otherwise received approval from DFS to engage in this activity.[13] LPTCs engaged in virtual currency business activity in New York are required to comply with the substantive provisions of the BitLicense regulation.[14]

When a VCE is approved to be licensed or chartered, DFS creates a detailed supervisory agreement that is tailored to the specific risks presented by the VCE's business model. Supervisory agreements are updated on an as-needed basis to take account of changing business models, market conditions, or other relevant considerations.

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[8] This consolidation was effected by New York's Financial Services Law. *See* § 102 thereof.

[9] The New York State Banking Department was established in 1851, while the New York State Insurance Department commenced operations in 1859*, see* https://www.dfs.ny.gov/our_history.

[10] New York State Department of Financial Services, *2021 Annual Report* (2022).

[11] BNY Mellon, *Annual Report 2022 at 6, available at* https://www.bnymellon.com/us/en/investor-relations/annual-report-2022.html; *see also*: The Depository Trust Company, *Annual Report 2022*, *available at* https://www.dtcc.com/settlement-and-asset-services.

[12] Specifically, 23 NYCRR § 200.2(q) defines "virtual currency business activity" to mean any one of the following activities involving New York or a New York resident: a) receiving virtual currency for transmission or transmitting virtual currency; b) storing, holding or maintaining virtual currency or control over virtual currency on behalf of others; c) buying and selling virtual currency as a customer business d) performing exchange services as a customer business; or e) controlling, administering or issuing a virtual currency.

[13] 23 NYCRR § 200.3.

[14] *See e.g.*, DFS press releases issued on October 5, 2015, and March 11, 2014, *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1510051 and https://www.dfs.ny.gov/system/files/documents/2020/04/ea140311_proposals_vc_exchanges.pdf.

VCEs also must get approval from the Department for material changes of business. Pursuant to 23 NYCRR § 200.10 and the supervisory conditions imposed on LPTCs, each VCE must obtain prior written approval for any plan or proposal to introduce or offer a materially new product, service, or activity, or to make a material change to an existing product, service, or activity. This requirement enables the Department to review material business changes for potential legal or regulatory issue and safety and soundness or operational concerns. It also enables DFS to review the change for consumer impact and approve or deny the change accordingly.

New York's regulatory framework for VCEs imposes robust requirements around capital adequacy, risk and transactional disclosures, changes of control, new business activities, books and records, and financial and event reporting.[15] In addition, we mandate that VCEs implement strong controls to verify that activity is conducted in a safe and sound manner:

- ***Cybersecurity.*** DFS's cybersecurity regulation is one of the first of its kind, requiring DFS-regulated entities, including LPTCs, to adopt risk-based cybersecurity controls to protect both their internal information systems as well as the nonpublic information they hold.[16] The cybersecurity regulation does this by requiring DFS-regulated entities, among other things, to: conduct regular cybersecurity risk assessments, penetration testing, and vulnerability assessments; maintain audit trails; limit access privileges and employ multi-factor authentication; utilize qualified cybersecurity personnel; maintain third-party service provider security policies; limit data retention; monitor the activity of authorized users; provide cybersecurity awareness training to all personnel; encrypt nonpublic information; maintain incident response plans; and notify DFS of specified categories of cybersecurity events within 72 hours.[17]

- ***Financial Crimes and Fraud.*** DFS's approach to financial crimes prevention has evolved along with the market, so that the Department has set the bar for anti-money laundering requirements for the broader virtual currency ecosystem. In 2015 under the BitLicense regulation, the DFS established annual requirements with respect to anti-money laundering risk assessments and independent testing requirements, with additional controls to address virtual currency-specific risk criteria.

  Effective January 1, 2017, the Department promulgated Part 504 – Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications,[18] which requires covered entities to monitor and filter transactions for potential illicit activity, to prevent transactions with sanctioned entities, and to certify compliance with the regulation annually to DFS. Part 504-specific requirements include, for example, Bank Secrecy Act

[15] Thus, DFS requires, among other things, that LPTCs regularly submit for the agency's review detailed financial reports in a form prescribed by the Superintendent of Financial Services, and immediately report to DFS upon discovery any evidence of misconduct in which any company employee or agent is involved. NYBL § 37, 3 NYCRR § 300(1)(a). Note too that DFS regulations specify the information to be set forth in the entity's report of the misconduct and require the entity to update DFS following any material developments in the matter.
[16] 23 NYCRR § 500. DFS proposed amendments to this Part which were published in the State Register on November 9, 2022. The Department is currently evaluating the responses received during the public comment period, which ended on January 9, 2023.
[17] 23 NYCRR § 500.
[18] 3 NYCRR § 504.

and anti-money laundering ("BSA/AML") detection scenarios with threshold values and amounts designed to detect potential money laundering or other suspicious or illegal activities; end-to-end, pre-and post-implementation testing of the Transaction Monitoring Program, including, as relevant, a review of governance, data mapping, transaction coding, detection scenario logic, model validation, data input and program outputs; and on-going analysis to assess the continued relevancy of the detection scenarios, the underlying rules, threshold values, parameters, and assumptions.

The Department frequently clarifies regulatory expectations in light of new circumstances, including changes in the geopolitical landscape and technological advances. For instance, on February 25, 2022, within 24 hours of the Russian invasion of Ukraine, the Department issued guidance related to the conflict,[19] which set out particular considerations related to Office of Foreign Assets Controls compliance specific to virtual currency, including the use of geolocation tools, IP address identification, and blocking capabilities to detect and prevent potential sanctions exposure. The Department also published guidance regarding the use of blockchain analytics, emphasizing to all VCEs the importance of blockchain analytics to effective policies, processes, and procedures, including, for example, those relating to customer due diligence, transaction monitoring, and sanctions screening.[20] In addition, the Department continues to augment its own capabilities in this space, now leveraging multiple blockchain analytics software vendor tools across its applications, supervision, and examinations process.[21]

- ***Custodial Practices.*** To safeguard customer assets, DFS requires VCEs that store, hold, or maintain custody or control of virtual currency on behalf of another must hold virtual currency of the same type and amount as that which is owed or obligated to such other person.[22] DFS custody requirements are set forth in each VCE's supervisory agreement. Based on DFS's experience regulating VCEs, in January 2023, DFS published guidance informing all VCEs of the Department's expectations regarding the appropriate custodial practices for maximizing client protection in the event of a custodian's insolvency.[23] The Proposed Rule's requirements track the Department's guidance in several key respects, including by emphasizing the need for custodians to maintain client assets in a properly titled "for-the-benefit-of" account, segregated from the custodian's proprietary assets and by prohibiting the custodian's use of client virtual currency assets for any proprietary purpose.

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[19] New York State Department of Financial Services, *Escalating Situation in Ukraine and Impact to Financial Sector* (February 25, 2022), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220225_ukraine_escalation_impact_financial.

[20] New York State Department of Financial Services, *Guidance on Use of Blockchain Analytics* (April 28, 2022), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics

[21] *See,* for example, *Governor Hochul Announces Actions to Strengthen Department Of Financial Services Enforcement Of Sanctions Against Russia* (March 2, 2022), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr20220302.

[22] 23 NYCRR § 200.9.

[23] New York State Department of Financial Services, *Guidance on Custodial Structures for Customer Protection in the Event of Insolvency* (January 23, 2023), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures.

- ***Capital Requirements.*** DFS-regulated VCEs are subject to robust capital requirements designed to address industry-specific risks. Each entity's required capital amount is calculated based on the particular risks presented by that entity's business model and other safety and soundness factors, including for example, the entity's custodial architecture model, volume and value of transmitted assets, and projected wind-down costs associated with business activity. Once the capital amount is initially determined with the Department, that entity must maintain at least 110 percent of that amount at all times. If an entity falls below the 110 percent threshold at any time, they must notify the Department immediately. This capital requirement serves to mitigate risks associated with a VCE, particularly those that could be serious to customers, including consumers, such as cyber events, market volatility, or other exogenous events. Entities must submit reports demonstrating that they are meeting the required amount.

- ***Consumer Protection.*** DFS's regulatory framework includes specific consumer protection requirements, establishing, among other things, advertising and marketing practices, proper disclosures, transaction receipts, and fraud prevention.[24] VCEs must adopt policies and procedures to resolve complaints in a fair and timely manner. [25]

  DFS works to address ongoing and emerging issues. For example, in 2018, DFS issued guidance reminding licensed entities of their responsibilities regarding preventing market manipulation and other wrongful activity.[26] DFS recently enhanced abilities to detect fraud and other illegal activity through risk monitoring tools.[27]

  The Department imposes detailed coin listing requirements establishing a comprehensive risk assessment framework intended to ensure that the coin and the uses for which it is being considered are consistent with the consumer protection and other standards embodied in 23 NYCRR Part 200 and with safety and soundness.[28]

In short, New York state regulators have been supervising financial institutions for nearly 200 years. By virtue of this experience, DFS has successfully built a robust prudential regulatory structure that provides New Yorkers have access to a well-regulated virtual currency marketplace.[29] Through its ongoing supervision, the Department continues to refine its regulation of entities and their activities, articulating its expectations for safe and sound operations in light of the evolving commercial and technological demands of the market.

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[24] 23 NYCRR §§ 200.18, 200.19.
[25] 23 NYCRR § 200.20.
[26] DFS Takes Action to Deter Fraud and Manipulation in Virtual Currency Markets (February 7, 2018), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1802071.
[27] DFS Superintendent Adrienne A. Harris Strengthens Departments Ability to Detect Fraud in the Virtual Currency Industry (February 21, 2023), *available at* https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202302211.
[28] New York State Department of Financial Services, *Guidance Regarding Adoption or Listing of Virtual Currencies* (June 24, 2020), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20200624_adoption_listing_vc.
[29] New York State Department of Financial Services, *Virtual Currency Businesses, available at* https://www.dfs.ny.gov/virtual_currency_businesses (last visited May 2, 2023).

3. Discussion

3.1. Application of the Proposed Rule on Banks

3.1.1. Commission's Regulatory Reach over Banks is Unwarranted

The Proposed Rule would indirectly undertake to regulate custodians, including banks, by mandating that investment advisers 1) enter into contracts with qualified custodians 2) require certain prescriptive provisions to be included in the contracts and 3) obtain written assurances regarding the custodian's practices. Requiring written instruments between an adviser and custodian is a significant departure from current practices, which the Preamble, itself, acknowledges, stating that "under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian."[30]

Nevertheless, the Proposed Rule would specify that advisers and custodians enter into written agreements that would require, among other things, that the qualified custodian:

- promptly, upon request, provide records relating to client assets held in the account (including directly to the Commission);
- at least quarterly, send account statements meeting specified requirements to both the clients and the adviser; and
- annually obtain a written internal control report from an independent public accountant relating to custodial services.[31]

The Proposed Rule further mandates that an adviser obtain additional written assurances from a qualified custodian that the custodian would, among other things:

- exercise due care in discharging its custodial duties including implementing appropriate measures to safeguard client assets from theft, misuse, and misappropriation;
- indemnify the client (and have insurance arrangements in place that will adequately protect the client) against the risk of loss in the event of the qualified custodian's own negligence, recklessness, or willful misconduct;
- clearly identify the client's assets, hold them in a custodial account, and will segregate all client assets from the qualified custodian's proprietary assets and liabilities.[32]

Congress has not authorized the Commission to regulate custodians directly. Nevertheless, these mandates effectively permit the SEC to exercise regulatory authority over custodians, some of which are extensively regulated under federal and state law. As explained in more detail below, the Commission's regulatory reach into banks is unnecessary considering the prudential regulation

[30] Preamble at 14745.
[31] Preamble at 14780.
[32] Preamble at 14781.

currently in place over banks and, more importantly, may have unintended consequences for investors.

Relatedly, the Commission also proposes to regulate contractual arrangements for private parties. The Proposed Rule would override the ability of parties to negotiate their own agreements. It is axiomatic that mutually agreed upon terms and conditions, particularly as they relate to the allocation of risk and liability, are essential to running any business—including that of a custodian. Such terms and conditions make it possible to anticipate costs, to evaluate risks and to formulate necessary fees and charges. Imposing a greater risk of liability on a custodian as contemplated in the Proposed Rule would result in additional fees passed onto investors.

3.1.2. Impact of the Proposed Rule's Asset Segregation Requirement on Banks

In the Preamble, the Commission expresses its understanding that while a bank deposit generally creates a debtor-creditor relationship, it would be more protective of client assets to hold them in a segregated account of the type contemplated by the Proposed Rule.[33] Holding assets in such an account, the Commission believes, would increase the likelihood that those assets would be returned to clients in the event of the bank's insolvency.[34] In addition, the Commission declares in the Preamble that it is "proposing to establish a consistent and uniform standard to protect all advisory clients"[35], regardless of any differences that may exist in the applicable custodial insolvency regimes.

While the Department generally supports the customer protection goals underlying the SEC's proposed asset segregation requirement, we do not believe that adopting a one-size-fits-all federal standard is appropriate. Implanting such a standard in the definition of a bank qualified custodian would effectively endow the SEC with unprecedented interpretative discretion over whether a particular custodial account structure was properly "designed". The assertion of such expansive authority would conflict with existing state and federal prudential frameworks.[36] Moreover, requiring a segregated client cash account in the nature of a bailment would be enormously costly and disruptive to existing business models with customers bearing the brunt of both the cost and the disruption.

In many cases, when a bank accepts client cash from an investment adviser today, it takes that cash onto its balance sheet and establishes a corresponding repayment obligation to the client, i.e., it accepts a general instead of a special deposit. Therefore, these funds become available to the bank for lending and other legitimate business purposes. In this regard, many custodian banks offer their customers cash management services which entail moving, managing, and monitoring cash positions associated with securities transactions. These services include investment of excess cash, online review of cash balances and projections, and facilitation of foreign exchange and hedging

[33] Preamble at 14683.
[34] *Id.*
[35] *Id.*
[36] For example, while the SEC notes that a bank custodian's account terms should identify clearly that the account is distinguishable from a general deposit account (Preamble at 14683), DFS does not adopt this requirement, and indeed, as explained more fully below, believes that it is ill-advised.

activities. This allows excess cash to be invested, often by a sweep mechanism, in vehicles selected by the customer. These vehicles include time deposits, shares of money market funds, short-term investment funds, and interest-bearing accounts in a variety of currencies. [37]

If bank custodians lose the flexibility to operate in this manner, a host of detrimental impacts for customers could ensue, including:

- Advisory clients might have to pre-fund their securities purchases or secure an alternative form of credit support to meet their settlement obligations because custodian banks would be impeded from advancing the necessary funds.

- Banks would need to overhaul their operating and accounting systems and build out special infrastructure for advisory client accounts, imposing costs on banks, exposing client transactions to increased operational risk, and slowing down transaction processing.

- Custody fees would spike for multiple reasons, including: a) to help defray the cost of the-required restructuring, b) to compensate for lost revenues on newly restricted deposits and c) to reflect increased, ongoing operating expenses within the bank.

- The ability of bank custodians to offer cash management services would be hampered, which could not only curtail a source of fee income for banks but more importantly make it more difficult for advisory clients to earn a return on their excess cash.

Finally, it is not clear what the consequences would be if, as mandated by the Proposal, the cash in a custody account were held by the bank as a special deposit rather than a general deposit – shown on its fiduciary rather than general ledger. Assuming that such cash were not placed in an investment vehicle under a cash management or sweep arrangement, a New York-chartered bank would have the authority, under Section 100b-1 of the NYBL, to self-deposit with itself cash awaiting investment or distribution – i.e., the bank acting as custodian would make a deposit with itself acting in its proprietary capacity, thus creating a debtor-creditor relationship.[38] Section 100–b.3 of the NYBL would grant a priority to these self-deposits. However, it is not clear how long such cash could be so held without losing its character as "awaiting investment or distribution," and therefore, the right to the priority. If a court later determined that at the time of failure of the bank custodian, the cash were no longer "awaiting investment or distribution," the protection afforded to such cash by the Proposal's asset segregation requirement might turn out to be a mere simulacrum.

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[37] The desirability of such cash management services has been to some extent been attenuated, but not eliminated, by the repeal of former Section 19(i) of the Federal Reserve Act, 12 U.S.C. § 371a, by Section 627 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") effective July 21, 2011. Section 19(i) had generally prohibited the payment of interest on transaction accounts. Also, effective March 26, 2020, the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") reduced the rate that reserves must be held against such transaction accounts under its Regulation D, 12 C.F.R. § 204, to zero percent. 85 Fed. Reg. 16525 (March 24, 2020.)

[38] A national bank would have similar authority under Section 9.10 of the Regulations of the Comptroller of the Currency. 12 C.F.R. § 9.10.

3.1.3. Impact of the Proposed Rule's Contractual Mandates on Banks

Under the Proposed Rule, a qualified custodian would be required to:

> (i) indemnify advisory clients—without condition—against any losses incurred as result of its own negligence, and
> (ii) have insurance arrangements in place that will adequately protect advisory clients against the risk of loss arising out of the custodian's misconduct, including simple negligence.[39]

The disruptive effects of these provisions may far outweigh their potential protective benefits for advisory clients. As a threshold matter, the Department understands that a significant number of bank custodians currently adopt a gross negligence standard of liability in their customer agreements.[40] Summarily changing this standard, to simple negligence would expose a bank custodian to a greater potential risk of liability that could materially impact the profitability of a bank's custodial business. Because the real-world impact of this provision and—together with the insurance requirement—has yet to be modeled and tested, some banks might be motivated to discontinue offering custody services for advisory clients[41], thereby reducing the pool of qualified custodians available to advisory clients.

In any event, the increased potential liability and costs implicit in the Proposal would impel significantly increased custody fees. Additionally, the Proposal would represent a significant departure from what the Department, as a prudential regulator of bank custodians, currently requires. Therefore, its adoption would not only usurp the banking regulators' supervisory judgment but would also inject unnecessary uncertainty and confusion into the marketplace. Lastly, because these provisions are so vague and leave such a significant number of questions unanswered, their efficacy would be problematic.[42]

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[39] Preamble at 14694.

[40] The application of a simple or gross negligence standard would be governed by the law applicable to the custodian agreement, which law would generally be that of a state. The concepts of simple or gross negligence could differ from state to state with one state's interpretation of negligence analogous to another's view of gross negligence. Nevertheless, the Commission does not clearly address how its mandated simple negligence standard would apply under the laws of the various states.

[41] Indeed, the Commission expects its setting the standard of custodial contractual liability at simple negligence to be highly impactful in the marketplace. (Preamble at 14746.)

[42] For example: Nowhere in the amendment is it indicated who would be tasked with determining a custodian's negligence or in what venue. Nor is any guidance provided on whether contributory or comparative negligence could be a valid defense to claim. Similarly, on the insurance issue, it is not completely clear how "adequacy" is to be measured or what happens if "adequate" insurance is unavailable? Also, would the rule prohibit self-insurance? This too is unclear.

3.2. Implications of the Proposed Rule on Virtual Currency

3.2.1. State-Chartered Trust Companies Should Continue to Be Able to Act as Qualified Custodians

Like the current Custody Rule, the Proposed Rule defines "qualified custodian" to include any "bank" as defined under the Adviser's Act; consequently, the Proposed Rule would continue to include state-chartered trust companies among the types of entities that may serve as qualified custodians.[43] However, the Preamble also calls into question the robustness of the regulation to which state entities are subject—and does so in a manner, according to Commissioner Uyeda, "as if to suggest that state-regulated banking entities are less trustworthy than federally chartered ones."[44]

The insinuation that state-regulated entities may be inadequately regulated for the purposes of customer asset safekeeping is troubling and unfounded. Indeed, DFS-regulated LPTCs are subject to intensive regulation and ongoing monitoring, such as in the areas of anti-money laundering and cybersecurity, where DFS-chartered entities are subject to higher formal requirements than those currently enforced by the federal regulators.

The national regulatory framework for crypto remains disjointed. The Department has provided a holistic regulatory framework for virtual currency business activity since 2015 that has evolved and grown with the marketplace.

Excluding LPTCs as entities eligible for qualified custodian status would be detrimental to investors. At present, there is not an overarching federal scheme to review and approve licenses for qualified custodians that intend to serve the virtual currency marketplace. Accordingly, if DFS-regulated LPTCs were no longer able to provide these services, investment advisers would have limited ability to transfer or hold certain asset classes, possibly forcing sales that would harm values and thus investors.

3.2.2. DFS's Virtual Currency Framework Exemplifies the Robust and Extensive Regulatory Structures over LPTCs at the State Level

Since 2015, New York has set the bar for prudential regulation of the virtual currency industry, leveraging a wide range of tools including licensing, supervision, examination, and enforcement. Further, as a prudential regulator, the Department is tasked with the dual imperatives of assuring the safety and soundness of our VCEs and ensuring that they adequately protect their customers.

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[43] New York's LPTCs are chartered and regulated under the NYBL, pursuant to which they possess the same general powers as banks, with the exception that LPTCs are permitted only to accept deposits and make loans that arise directly from the exercise of their fiduciary powers. In addition, LPTCs are empowered under the NYBL to provide custody and related services in a fiduciary capacity. *(See* NYBL § 100.) As a result, New York's LPTCs are clearly capable of satisfying the Advisers Act's definition of "bank."

[44] *See* Question 19 of the Proposal at 14685; *See also* SEC Commissioner Uyeda's *Statement on Proposed Rule on Safeguarding of Advisor Client Assets* (February 15, 2023), *available at* https://www.sec.gov/news/statement/uyeda-statement-custody-021523.

DFS's holistic approach to regulation of VCEs ideally positions DFS to understand and protect consumer interests, both by caring for the integrity of the entities with which they interact and by directly regulating interactions between those entities and their consumers. In contrast, an approach reliant solely on markets-based regulation risks eroding many of the standards that the Department has consistently upheld.

Below, we provide a summary of key components of our VCE regulatory framework, as it relates to LPTCs, which serve as the qualified custodians addressed in the Proposal.

LPTC Chartering Process

In order to receive approval to charter, each LPTC must undergo a robust application process in which DFS staff vets, in particular, the applicant's:

- principals and control persons;
- operating model;
- financial statements and projections;
- vendor relationships; and
- compliance and risk management infrastructure.

As part of this vetting process, LPTC applicants must demonstrate their ability to comply with DFS's program requirements relating to cybersecurity, anti-money laundering, custodial practices, capital requirements, consumer protection, and character and fitness requirements.

Finally, when an entity is chartered, DFS establishes a detailed supervisory agreement that is tailored to the specific risks presented by the LPTC's business model. These supervisory agreements enable DFS to take supervisory action as required and are updated on an as-needed basis to address changes to business models (for example, related to the development of novel activities) and to respond to evolving market conditions or other relevant considerations. Once chartered, LPTCs authorized to engage in virtual currency business activity must obtain Department approval for material changes of business, including for new product offerings such as with respect to stablecoin issuance.

Supervision

DFS has broad authority to oversee LPTCs' activities and to issue rules, regulations, and orders that operate to ensure the safe and sound conduct of chartered institutions.[45] For example, each LPTC is required to meet with its DFS supervisors on a periodic basis to provide updates on key business and compliance developments and to address any outstanding questions or concerns the supervisory team may have. In addition, on an ongoing basis, the Department's supervisory team:

- closely monitors all corporate governance, compliance and financial reports filed by LPTCs with DFS, taking follow-up action as appropriate;

[45] NYBL §§ 10, 14.

- assesses any material change of business or change of control requests an LPTC may submit; and
- tracks and addresses the LPTC's remediation of outstanding examination findings.

A key component of the Department's oversight is the requirement for the LPTCs to receive prior written approval from the Department for any material changes of business. This process enables DFS to review the change for consumer impact and approve or deny the change accordingly.

Examinations

DFS examines LPTCs pursuant to the NYBL to assess whether the entity operates in a safe and sound manner, provides fair access to financial services, treats customers fairly, and complies with applicable laws and regulations.[46] DFS has authority to conduct examinations at any point in time. Accordingly, DFS can examine those LPTCs that present higher risks more frequently than the standard 24-month review cycle. This can be in response to, for example, significant market events (such as wide-scale bankruptcies disrupting market operations), the unfair treatment of customers, or noncompliance with laws and regulations. Examinations afford the Department an opportunity to conduct a comprehensive assessment of a chartered entity's business and risk practices, as well as an opportunity to assess the effectiveness of its internal controls, including, for example, safeguarding client assets and assuring compliance with applicable law. The scope of each DFS examination is determined through risk-based analysis that assesses entity-specific risks and corresponding controls, as well as requirements specific to the Department, generally taking place over a several weeks planning period and communicated to the LPTC via a "first day request letter."

Once the examination commences, DFS examiners inspect electronic and written records of the LPTC, interview company employees, and review corporate governance activities, including board and management committee minutes. At the conclusion of an examination, DFS prepares a Report of Examination ("ROE") in which DFS examiners issue findings and recommendations for improvements, known as "Matters Requiring Attention" or "MRAs." As appropriate, examiners may also designate certain "Matters Requiring Immediate Attention" or "MRIAs," mandating remediation on an expedited basis. The ROE also includes examination ratings in accordance with the Federal Financial Institutions Examination Council ("FFIEC") Uniform Financial Institutions Rating System (Commonly known as CAMELS), Uniform Rating System for Information Technology, and Uniform Interagency Trust Rating System. The examination process is modeled on the trust manuals issued by the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve and on the Office of the Comptroller of the Currency's Comptroller's Handbooks. Additionally, DFS examiners use the interagency guidance issued by the FFIEC to review compliance for BSA/AML while also examining for compliance with the Department's 504 requirements (pertaining to AML) and with the DFS's part 500 requirements (pertaining to cybersecurity). Finally, the DFS has a robust examiner training curriculum that includes FFIEC training where DFS examiners attend the same training as the Federal Deposit Insurance Corporation, Federal Reserve, and Office of the Comptroller of the Currency examiners.

[46] NYBL § 36

Enforcement

LPTCs are also subject to DFS's investigatory, enforcement, and sanctioning powers. DFS investigates whenever there is a reasonable suspicion that a person or entity within the Department's jurisdiction has engaged in fraud or has violated the NYBL, NYFSL, or the regulations promulgated under those statutes, including provisions concerning safety and soundness, consumer protection, cybersecurity, transaction monitoring, and BSA/AML compliance.[47] DFS is empowered to require the production of documents, to take testimony, and has subpoena power without regard to whether the subpoenaed party is licensed by DFS.[48] Moreover, DFS has the discretionary authority to issue an order requiring a chartered institution to discontinue any unsafe or unsound practice and may impose civil monetary penalties for any violation of the NYBL, NYFSL, or the regulations promulgated thereunder.[49]

The Department has an active and experienced regulatory enforcement division. License revocation, mandated remediation, monitorships, and substantial civil monetary penalties are all tools in DFS's regulatory toolkit, and the Department has been a leader with respect to enforcement in the virtual currency space. Indeed, two of the most substantial enforcement actions involving virtual currency entities have been the result of DFS investigations:

- In August 2022, the Department entered into a consent order with Robinhood Crypto, LLC ("RHC") for compliance failures that resulted in violations of the Department's virtual currency, money transmitter, transaction monitoring, and cybersecurity regulations. Pursuant to the settlement, RHC agreed to pay a $30 million penalty and retained an independent consultant to review, report on, and assist RHC in remediating the compliance deficiencies identified during the Department's investigation.[50]

- In January 2023, DFS imposed a $50 million penalty on Coinbase, Inc. for significant failures in Coinbase's compliance program that violated the NYBL and DFS's virtual currency, money transmitter, transaction monitoring, and cybersecurity regulations. These failures made the Coinbase platform vulnerable to serious criminal conduct, including, among other things, fraud, possible money laundering, suspected child sexual abuse material-related activity, and potential narcotics trafficking. In addition to the penalty, Coinbase agreed to invest an additional $50 million in its compliance function over the next two years to remediate the issues and to enhance its compliance program pursuant to a plan approved by DFS. A monitor that was appointed by DFS in 2022 will assess Coinbase's remediation efforts.[51]

Robust Regulatory Structure

To underscore how the Department's approach leads in this space, many of the specific gaps and deficiencies identified through examinations and subsequent enforcement review, from

[47] NYBL § 78, NYFSL § 404.
[48] NYFSL §§ 102, 408.
[49] NYBL §§ 44(1)(c), 44 (4).
[50] *Supra* note 7.
[51] *Id.*

cybersecurity lapses to anti-money laundering, reflect requirements that do not exist under some activities-based frameworks. For example, LPTCs are subject to regulations governing the following cybersecurity requirements not clearly addressed by federal regulatory structures including:

- information security;
- data governance and classification;
- asset inventory and device management;
- access controls and identity management;
- business continuity and disaster recovery planning and resources;
- capacity and performance planning;
- systems operations and availability concerns;
- systems and network security;
- systems and network monitoring;
- systems and application development and quality assurance;
- physical security and environmental controls;
- customer data privacy;
- vendor and third party service provider management;
- risk assessment;
- monitoring and implementing changes to core protocols not directly controlled by the entity; and
- incident response.

Such standards are critical to safeguarding customer assets in the virtual currency space and, therefore, any exclusion of state chartering and supervision of qualified custodians would deprive the market of many important investor and consumer protections.

3.2.3. DFS Applies its Extensive Experience to Regulate Digital Asset Custodians, Compelling Them to Stay Regulated

Over the past seven years, DFS staff has developed regulatory proficiencies applicable to LPTCs in areas ranging from capital adequacy and consumer protection to transaction monitoring and cybersecurity.

Recent DFS guidance for LPTCs includes:

- Guidance on Prevention of Market Manipulation and Other Wrongful Activity (2018)[52]
- Guidance Regarding Adoption or Listing of Virtual Currencies (2020)[53]
- Guidance on Use of Blockchain Analytics (2022)[54]

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[52] *Supra* note 26.
[53] *Supra* note 28.
[54] *Supra* note 20.

- Guidance on the Issuance of U.S. Dollar-Backed Stablecoins (2022)[55]
- Guidance on Custodial Structures for Customer Protection in the Event of Insolvency (2023)[56]

Guidance such as these, as well as the swift response to market events that DFS frequently provides, helps to foster a safer operating environment. Any rulemaking that excludes the states' ability to regulate innovative financial services would run the risk of pushing novel activities into an unregulated space—including completely offshore—and would be destructive of the regimes that provide value to investors, to the detriment of safety and soundness of the financial system.

3.2.4. DFS-Chartered LPTCs Are Important Digital Asset Custodians in the United States and Should Be Permitted to Continue in That Role

New York's LPTCs not only have developed a specialized expertise with regard to digital assets, but they have also built technologies, processes, and controls that are calibrated to the proper handling of these assets. Many of these processes and controls were put into place as a direct result of DFS's regulatory requirements. The Department's requirements, moreover, often impose higher standards on its regulated entities that are sometimes adopted by other regulators. For instance, DFS's cybersecurity regulation has been used a model by other regulators in the United States and abroad leading others to adopt similar requirements.[57] DFS mandated a Transaction Monitoring and Filtering Program to monitor transactions subsequent to execution for potential BSA/AML violations and suspicious activity reporting that is more stringent than the federal corollary requirement.[58] These requirements codified in Part 504 were promulgated as a response to various shortcomings found in the federal regulations.[59]

Indeed, because New York City is an international hub for financial institutions, DFS's regulatory regime effectively mandates industry-wide compliance. Impairing LPTCs' ability to attain qualified custodian status under the Advisers Act would undermine, rather than enhance, investor protection. As described above, the DFS regulatory regime, in place since 2015, has evolved in real-time to meet the changing risks of the marketplace to consumers. As a result, LPTCs overseen by the Department have changed and improved their practices to meet DFS's evolving compliance requirements. The benefits of this supervision and effective compliance regime inures to the benefit of investors only to the extent that the Department is able to continue to have its prudential jurisdiction over supervision of those LPTCs serving as qualified custodians.

Excluding state-chartered trust companies from the qualified custodian definition would also deprive SEC-registered advisers of the ability to utilize best-in-class digital asset custodians and leave them with only a few, less-experienced entities as options for custodying their clients' digital

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[55] New York State Department of Financial Services , *Guidance on the Issuance of U.S. Dollar-Backed Stablecoins* (June 8, 2022), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220608_issuance_stablecoins.

[56] *Supra* note 23.

[57] 23 NYCRR § 200.16.

[58] For example, § 504 requires an annual submission to DFS confirming compliance with the regulation that is not similarly required under federal law.

[59] See 3 NYCRR § 504.1.

asset investments. Without competition, fees naturally rise, and investment advisors would be forced to choose among a pool of custodians with higher prices less rigorous standards than currently available.

3.3. State Law Should Govern Assessment of State-Chartered Entities

DFS is aligned with the SEC on the need for qualified custodians to be subject to, and comply with, strong asset segregation requirements. However, the Department believes that state banking authorities are best positioned to implement and enforce such asset segregation requirements with respect to state-chartered entities. The supervision of state-chartered custodians has traditionally resided with the states, and it is the state supervisors and examiners who have the hands-on experience to address any compliance issues with those entities and the applicable requirements. Consequently, state regulators are best suited to make a determination of whether the custodian properly "holds the 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," as required by the Proposed Rule.[60]

The resolution of insolvent state-chartered banking institutions is primarily a matter of state law. The Department therefore urges the Commission to defer to state law with respect to the asset segregation requirement for state-chartered entities.

Embedding an asset segregation requirement without proper acknowledgement of existing state law and precedent would run counter to the basic principles underlying this nation's dual system of banking, which has been in place for more than 150 years and which contemplates parallel state and federal trust regulators working in concert to secure the safety, soundness, and resilience of the nation's banking organizations. A clear endorsement of this concurrent and parallel authority can be seen in Congress's decision to include both state and federal trust companies in the definition of a "bank" under the Advisers Act.[61] The original balance of authority reflected in the Advisers Act signals Congress's intent to see federal and state trust companies treated as equals. To newly limit state sovereignty in determining the appropriate scope of asset segregation by state-chartered trust companies would not only fail to recognize that states are generally considered best suited to serve as laboratories of innovation and change (and thereby best able to account for quickly changing technologies and market behaviors), it would also be at odds with the plain meaning of the Advisers Act.

3.4 The Proposed Possession or Control Requirement Harms Consumers

The Proposed Rule requires that qualified custodians maintain at all times "possession or control" of client assets.[62] This means that (1) the qualified custodian would be required to "participate in any change in beneficial ownership of [the] assets," (2) the qualified custodian's participation "would effectuate the transaction involved in the change in beneficial ownership," and (3) the

[60] Preamble at 14683, 14783; Proposed Rule 223-1(d)(10)(i).
[61] *Supra* note 4.
[62] Preamble at 14689.

qualified custodian's participation would be a "condition precedent to the change in beneficial ownership."[63]

The Preamble sets forth the SEC's belief that, under existing regulatory structures, qualified custodians are generally considered to have possession or control of assets when they are in exclusive or physical possession or control of those assets[64] but at the same time acknowledges that demonstrating exclusive possession or control is not the only way of meeting the proposed standard.[65] Specifically, the Commission explains that as long as a crypto custodian generates and maintains private keys in a manner such that an adviser would be unable to change beneficial ownership of client assets without the custodian's involvement, the proposed standard would be met.[66]

The SEC's goal of improving the safeguarding of customer assets can be best achieved through measures directly addressing the technological aspects of digital assets rather than the definitional status of intermediaries. DFS shares the Commission's concern that the proposed definition of "possession or control" may be more challenging in the context of digital assets than in traditional markets. One reason for these challenges is that a significant number of crypto trading platforms are not formed as trust companies and thus are non-qualified custodians ("Non-QC Platforms").[67] According to the Commission, where a transaction is pre-funded by an adviser with client assets on a Non-QC Platform, that would likely cause a violation of the Proposed Rule, because, from the point of pre-funding, the subject assets would be out of the qualified custodian's possession or control.[68]

DFS's concern centers on the fact that the Proposed Rule could harm investors by impairing their ability to pre-fund Non-QC Platforms, thereby excluding transaction execution on those platforms. Pre-funding serves a legitimate credit risk-mitigation function for Non-QC Platforms. Under the Proposal, Non-QC Platforms would be required to either drop their trade pre-funding requirements, injecting greater risk into their operating model, or stop providing services to investment advisor clients. If a Non-QC Platform chooses not to require pre-funding, credit exposure increases significantly, such that a failure to pay for a trade could, in a worst case scenario, bankrupt the Non-QC Platform and harm all investors it served. If Non-QC platforms exit the industry, the ramifications for the crypto marketplace could be harmful to consumers including:

- Liquidity drying up on platforms determined to not meet a new qualified custodian standard, leaving funds and investors in those funds holding illiquid, value-impaired assets;
- Spreads widening for retail investors on remaining venues, leading to increased costs on platforms as advisers attempt to find liquidity; and
- Runs on assets, resulting in severe price impacts to portfolios.

[63] Proposed Rule 223-1(d)(8).
[64] Preamble at 148687, 148688
[65] *Id.* at 14689.
[66] *Id.*
[67] These would include BitLicense entities.
[68] Preamble at 14689.

Instead, there are better means to satisfy the Commission's policy objectives of protecting client assets from unauthorized disposition, focusing on the risks of the qualified custodian entity rather than the technical classification of the intermediaries through which assets transfer. For example, through its supervisory agreements with LPTCs, DFS requires each entity to hold a certain level of capital against their specific business model. As a threshold matter, entities must hold virtual currency of the same type and amount, on a one-to-one basis, as that owed or obligated to a consumer. This is distinct from traditional banking based on a fractional reserve system, which enables entities to maintain only a portion of assets deposited by consumers and lend or use the rest for their own business. The DFS's approach to VCE capital helps ensure that appropriate financial resources are available to cover any potential losses or liabilities that may arise from the custody of users' virtual currency. DFS also performs rigorous reviews of each licensed entity's controls to secure and limit access to private keys. Codifying a standard methodology for key management is another measure that would serve the safeguarding purposes of the Proposed Rule without the potential impacts to liquidity leading to devalued portfolios.

4. Conclusion

DFS shares the Commission's interest in customer protection and supports the Commission's efforts to strengthen the custody protections for advisory client assets. The Commission should carefully consider any unintended consequences of the Proposed Rule on banks operating as qualified custodians and subject to a prudential regulatory system grounded in safety and soundness principles. As explained above, the Commission's indirect regulation of these banks would likely impair the investor protection it seeks to achieve through the Proposed Rule, an unnecessary result considering the robust supervision to which these entities are subject.

DFS urges the Commission to retain within the Safeguarding Rule, without restriction, the ability of state-chartered trust companies to serve as qualified custodians—a well-tested regime currently codified in the Custody Rule and relied on by industry participants. Preserving this structure would be in the best interest of consumers, allowing them to maintain existing relationships and current holdings with best-in-class custody providers, who in turn are subject to the industry-leading prudential regulation and supervision of DFS.

Precluding state-chartered trust companies from serving as qualified custodians would go against the plain intent of the Advisers Act and would be antithetical to the goal of investor protection. DFS has proven that it is best situated to provide clear guidance and swiftly respond to market events for a fast-moving evolving cohort of market participants. DFS's role not only ensures a safe space for entities to innovate and operate, but above all else, benefits consumers by promoting investor protection and fostering a healthy and trustworthy market.

Furthermore, any rulemaking that preempts the states' ability to regulate innovative financial services would run the risk of pushing novel activities into unregulated spaces, including offshore, and would be destructive of the existing regimes that provide great value to investors and to the detriment of safety and soundness to the financial system.

Lastly, DFS has implemented specific requirements for our regulated custodians that have demonstrably benefited New Yorkers in the face of market volatility and fraudulent behavior.

These requirements cover areas such as cybersecurity, financial crimes and fraud prevention, custodial practices, capital requirements, and consumer protections. Specifically, DFS's requirements have not only proven to be beneficial in protecting New York consumers against fraudulent behavior and market volatility but have also had an industry-wide effect, encouraging broad adoption of rigorous compliance frameworks.

The DFS's role in regulating qualified custodians builds on longstanding principles of dual banking in the United States, recognizing the authority of states in regulating financial services within their jurisdictions. The ongoing preservation of the federalist compromise reflected in the dual banking system also helps allay some of the regulatory uncertainty present at the national level, providing clear and consistent predictable regulatory floor of compliance for consumers and industry participants alike.

Thank you for the opportunity to provide comments on the Proposal. We look forward to working with you and our other federal counterparts in crafting a regulatory system that regulates the financial services industry through transparent rulemaking with meaningful consumer protective measures.

Respectfully submitted,

Peter C. Dean
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