Bain Capital Crypto >I< DRAGONFLY ELECTRIC CAPITAL HAUN

May 8, 2023

BY ELECTRONIC SUBMISSION

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

Re: File No. S7-04-23, RIN 3235-AM32, Safeguarding Advisory Client Assets

Dear Ms. Countryman:

Bain Capital Crypto, LP, Dragonfly Digital Management, LLC ("Dragonfly"), Electric Capital Partners, LLC ("Electric Capital"), Haun Ventures Management LP ("Haun Ventures"), and Ribbit Management Company, LLC ("Ribbit Capital") (each, a "Firm," and collectively, the "Firms") appreciate the opportunity to comment on the proposal by the Securities and Exchange Commission (the "SEC" or "Commission")[1] to modernize the custody rule, Rule 206(4)-1(the "Custody Rule") under the Investment Advisers Act of 1940 (the "Advisers Act"), and address how investment advisers safeguard client assets through proposed Advisers Act Rule 223-1 ("Rule 223-1").

Each of the Firms is registered as an investment adviser with the Commission and, as of March 30, 2023, the Firms collectively manage over $15 billion in assets, including crypto assets, for private fund and institutional clients.

- Bain Capital Crypto, LP is Bain Capital's crypto-dedicated venture capital fund adviser launched in 2021. Its team of investors, researchers, and regulatory experts support projects building blockchain-based infrastructure and applications from the seed through growth stage with a highly technical and collaborative approach.

- Founded in 2018, Dragonfly is a global, crypto-focused investment firm. With a deep expertise in technology, economics, and finance, its investment team takes a long-term research driven approach to capital deployment.

- Founded in 2018, Electric Capital is a California-based venture capital firm investing in early-stage technology companies focusing on cryptocurrencies, blockchain, fintech companies, and marketplaces.

[1] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672 (Mar. 9, 2023) (the "Proposal").

- Founded in 2022 by former federal prosecutor and Andreessen Horowitz general partner Katie Haun, Haun Ventures is a venture capital firm dedicated to making venture investments across the digital asset ecosystem. The firm's leadership team comprises individuals with deep operational expertise as well as extensive experience serving at the highest levels of government.

- Ribbit Capital is a global investment firm focused on the intersection of financial services and technology. Founded in 2012, Ribbit Capital's mission is to change the world of finance by providing capital and guidance to visionary financial services entrepreneurs around the world. Ribbit Capital's portfolio consists of more than 120 private and public company investments across six continents and a multitude of sectors within financial services, including payments, personal finance, investments and wealth, lending, insurance, crypto assets, financial infrastructure, financial software, and home finance.

INTRODUCTION AND EXECUTIVE SUMMARY

The Firms are supportive of the SEC's efforts to modernize the existing Custody Rule and to make it more comprehensive. However, we respectfully recommend that the Commission add additional provisions to the rule and make clarifications in the adopting release for the final Rule 223-1 to ensure that the Firms can continue to meet their fiduciary duties to their investors. Further, in its efforts to modernize the Custody Rule, we respectfully urge the SEC to consider industry perspectives to understand fully how the Proposal will work in regular commercial practice. Importantly, while the Firms support the SEC's efforts to modernize the Custody Rule, the Firms' comments should not be viewed as an endorsement of the view that crypto assets are securities subject to the federal securities laws. Indeed, it is not necessary to make this determination at all given the asset-agnostic approach of proposed Rule 223-1.

In framing our comments, we note that the crypto asset market is rapidly evolving both from a product and regulatory perspective. However, we also emphasize that market participants have already invested substantial time, energy, and capital in developing thoughtful solutions to ensuring that crypto assets can be safely and securely custodied on behalf of clients. We believe it is important to incorporate industry best practices into the current Proposal in order to ensure that the final rule remains adaptable to advances in this emerging technology sector, but also to ensure that the rule meets the Commission's stated objectives of mitigating principal-agent conflicts and preventing misappropriation of client assets.

As discussed more fully below, the Firms:

- Support Rule 223-1's position that a qualified custodian does not necessarily require exclusive possession or control to fulfill its duties;

- Submit that Rule 223-1 should permit the pre-funding of crypto assets on trading platforms that are not qualified custodians, provided certain conditions are met;
- Submit that Rule 223-1 should permit the adviser to self-custody crypto assets where there is no available qualified custodian on the same basis as it allows self-custody of privately offered securities and physical assets; and
- Submit that the definition of qualified custodian set forth in Rule 223-1, which is the same as under the current Custody Rule, should remain as drafted and the new safekeeping protections imposed by the rule should apply equally to all qualified custodians.

DISCUSSION

I. The Firms are supportive of the proposed rule overall, provided it addresses the safekeeping of crypto assets in a manner that enables advisers to fulfill their fiduciary duties to clients.

As the Proposal details, the current Custody Rule is both incomplete and antiquated. Even though the Custody Rule has been updated on several occasions since it was first adopted in 1962, it does not cover the range of assets for which investment advisers provide professional management services to clients, nor does it fully reflect the technological nature of how many managed assets are held by market participants.[2] In addition to advice on assets that are deemed "securities" or "funds" under the federal securities laws, many investment advisers have long provided professional management services for assets, such as physical commodities and real assets. This is also true for crypto assets. Innovation in financial products, including the development of OTC derivative products and the dematerialization of securities, has sometimes led to intractable compliance questions under the Custody Rule. The SEC staff has provided no-action and other guidance to address these market innovations over time, but we agree with the Commission that an overhaul of the entire framework is advisable. Investment advisers need a unified and consistent framework for the custody of client assets of all types in order to provide investors with professional investment management services.

New Rule 223-1 makes inroads in providing this needed framework and attempting to establish consistent rules to safeguard all assets for which investors are seeking professional management from their registered advisers. However, as we discuss further below, certain elements of the Proposal as it applies to crypto assets undermine the Commission's stated goals and interfere with advisers' abilities to fulfill their fiduciary duties to clients.

---

[2] *See* Proposal at 14,673-14,676 (Section I.A). For example, the current Custody Rule "excludes assets such as privately issued uncertificated securities, bank deposits, real estate assets, swaps, and interests in other private investment funds." Proposal at 14,674 n. 14. Similarly, since the SEC last amended the Custody Rule in 2009, more registered investment advisers have started to manage crypto assets for clients, which use distributed ledger or blockchain technology to record the ownership and transfer of assets. Proposal at 14,676.

II. Rule 223-1 must permit pre-funding of crypto assets on trading platforms without the platform itself needing to be deemed a qualified custodian, provided that certain conditions are met. This is imperative for advisers to meet their fiduciary duties of care and best execution.

Proposed Rule 223-1 requires a qualified custodian to maintain "possession or control" of an advisory client's assets.[3] This dual construct of possession or control is consistent with current practice under the Custody Rule and appropriately recognizes that many securities, such as privately offered securities and other assets, are dematerialized, cannot be held physically by a qualified custodian, and that effective control of an asset can be demonstrated through means other than actual possession. In the context of crypto assets, the Proposal properly acknowledges that control of crypto assets is properly evidenced when a custodian "generates and maintains private keys for wallets holding advisory client crypto assets in a manner such that an adviser is unable to change beneficial ownership of the crypto asset without the custodian's involvement."[4]

The Proposal notes that a qualified custodian need not have "exclusive control" of an advisory client's assets and that, in the context of crypto assets, where there may be multiple copies of private keys needed to access the wallet holding an advisory client's crypto assets, exclusive control is not needed, provided that the crypto asset cannot be transferred without the involvement of the qualified custodian. We agree that exclusive control should not be required for crypto assets, or indeed any asset, under new Rule 223-1 and that this construct is essential in the context of the modern financial world where uncertificated and dematerialized financial assets predominate.

It is with this construct in mind that we respectfully urge the SEC to acknowledge affirmatively in the Adopting Release that final Rule 223-1 would permit the pre-trade placement of crypto assets on a crypto asset trading platform that is not itself a qualified custodian (i.e., pre-funding).[5] This acknowledgement is important to clarify inconsistency in the Proposal. Specifically, immediately after the Proposal provides that exclusive control is not required in the context of crypto assets, the Proposal acknowledges that the majority of crypto assets trading occurs on platforms requiring pre-funding[6] but notes that the pre-positioning of an advisory client's crypto assets on a trading platform that is not a qualified custodian would violate both the current Custody Rule and new Rule 223-1.

---

[3] 17 C.F.R. § 275.223-1(a)(1)(i).

[4] Proposal at 14,689.

[5] Today, most centralized crypto asset trading platforms operating in the US are registered at the state level as money services businesses even if they are affiliated with a state trust that falls within the definition of "qualified custodian." As further described herein, the regulation of crypto platforms is rapidly evolving. *See infra* note 9 and accompanying text.

[6] Proposal at 14,740.

We believe that it is important for the SEC to state that pre-positioning of advisory client crypto assets on a crypto asset trading platform, regardless of its status as a qualified custodian, is consistent with new Rule 223-1 provided two conditions are met. The first condition is that the investment adviser has reviewed the trading platform's safeguards against loss of assets by theft or otherwise and has concluded that those safeguards are reasonably designed to protect against the risk of loss.[7] The second condition is that the adviser discloses in writing any identified material risk of loss related to the pre-funding of crypto assets on a trading platform to the client at the time the client engages the adviser to provide investment advice related to crypto assets.[8] These conditions are consistent with the asset-agnostic approach to a unified and coherent framework for safeguarding client assets. Permitting pre-positioning with these conditions enhances, rather than undermines, the certainty and clarity of how Rule 223-1 will apply to new and innovative products that develop in the future.

We recognize that the regulation of crypto asset trading platforms is evolving rapidly and is a matter of concern for the SEC.[9] However, we believe that the safeguards we have suggested above allow the SEC to permit pre-funding of advisory client crypto assets on trading platforms that are not themselves qualified custodians. This is true of many crypto asset trading platforms, so this revision is imperative to allow advisers to access the best sources of liquidity for crypto assets[10] while the Proposal, as drafted, would potentially cause advisers to violate their fiduciary duties of care and best execution[11] and place clients of registered advisers at a significant

[7] This condition is consistent with the approach taken in Rule 17f-7(a)(1)(ii) of the Investment Company Act of 1940, which places a requirement on the fund's custodian to assess and monitor the custody risks associated with placing a fund's foreign securities with an eligible securities depository. We believe that, in reviewing a trading platform's safeguards against risk of loss of crypto assets placed on the platform, an adviser should be able to rely on information about the safeguards provided by the trading platform and need not independently verify or test the accuracy of that information prior to the placement of client crypto assets on the platform.

[8] Such disclosure could be included in a written investment advisory agreement or in the offering materials for investors in any private fund vehicle advised by the investment adviser.

[9] The SEC, and in particular, Chair Gensler, has taken the position that crypto asset trading platforms may be operating as unregulated broker-dealers or exchanges. *See, e.g.*, SEC's Gensler Says Crypto Lacks Compliance, Not Clarity (Apr. 27, 2023), https://www.law360.com/articles/1602112. We believe that the SEC does not need to reach a formal conclusion on that position in order to proceed as we propose in this comment letter. Indeed, we believe that new Rule 223-1 should be focused solely on principles supporting the safekeeping of advisory client assets and should not be used as a lever to force regulatory status change of crypto asset trading platforms without legislative action.

[10] As noted above, in the Proposal, the SEC acknowledges that the majority of crypto asset trading occurs on platforms that require pre-funding and that are not qualified custodians. Proposal at 14,740. Thus, it is critical for an adviser to be able to transact on these platforms in order to access the majority of liquidity for crypto assets and comply with its duties of care and best execution.

[11] In this regard, we would argue that the SEC's conclusion that pre-funding of crypto assets on platforms that are not qualified custodians is not allowed under Rule 223-1 must be weighed against the harm such a position would do by foreclosing a registered adviser's ability to seek the best sources of liquidity and execution for crypto assets. We do not believe that the SEC has established a record to support the conclusion that the risk to safekeeping posed by crypto trading platforms outweighs a registered adviser's foundational duties of care and best execution.

disadvantage to other market participants, including un-advised retail crypto investors, in accessing liquidity for crypto assets.

III. The rule should permit the adviser to "self-custody" crypto assets when there is no available qualified custodian.

As currently drafted, new Rule 223-1 permits a registered adviser to self-custody "privately offered securities" and "physical assets"[12] under certain limited circumstances and subject to certain verifying conditions.[13] The Proposal then distinguishes how ownership is recorded for crypto assets from privately offered securities. But there is no explanation or evidence as to why the difference in recordkeeping makes crypto assets less (not more) suited to self-custody than privately offered securities. For crypto assets (including crypto asset securities), ownership is evidenced "on public, permissionless blockchains through public keys or wallet addresses" as opposed to privately offered securities "which can only be recorded on the non-public books of the issuer or its transfer agent…."[14] We would argue, respectfully, that in many cases "public permissionless blockchain" evidence of ownership can be more secure and transparent than a private issuer's internal books (particularly with respect to foreign private issuers) with it being difficult to conceal misconduct on a public blockchain.[15]

We believe that, as drafted, new Rule 223-1 is unnecessarily narrow in its limitation of adviser self-custody to privately offered securities and physical assets, particularly as it relates to the self-custody of crypto assets. Further, we believe that there is no policy reason for this limitation and that the SEC has not provided any analysis required under Section 202(c) of the Advisers Act to justify the limitation. Rather, the conditions that new Rule 223-1 requires for the self-custody of privately offered securities and physical assets work with equal force in the context of crypto assets.

The conditions that new Rule 223-1 imposes for self-custody of privately offered securities and physical assets by registered advisers work equally well in the context of crypto assets. We discuss each condition in turn:

a. <u>The adviser reasonably determines and documents in writing that ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession, or control transfers of beneficial ownership, of such assets.</u>

---

[12] "Physical assets" are not defined with specificity for purposes of new Rule 223-1, but the Proposal concluded that, like other "digitally maintained assets," crypto assets would fall outside the "plain language of the phrase" physical assets. Proposal at 14,706.

[13] Proposal at 14,704-14,710 (Section II.C).

[14] Proposal at 14,706.

[15] Further, the supposition that a private issuer's own books and records alone, and without other contractual protections, are sufficiently secure is inconsistent with the SEC staff's no-action positions requiring additional contractual protections in certain instances where private unregulated actors maintain share registers for foreign issuers. *See, e.g.*, Templeton Russia Fund, Inc., SEC No-Action Letter (Apr. 18, 1995).

There are many instances where a qualified custodian might not be available[16] for certain crypto assets. For example, venture capital firms commonly receive crypto assets that are nascent. As such, custodians (whether qualified or not) may not yet have the technological ability to custody and provide support when the adviser first receives such crypto assets. The length of time it takes for custodians to support any given crypto asset can vary based upon a number of factors, including unique technical integrations that may be required and the market demand for support. Unlike with other assets, there is no "one-size-fits-all" approach. For a qualified custodian to support a particular crypto asset requires a large upfront investment of operational resources. This is ultimately a business decision for the custodian as to whether to support a particular asset. Therefore, during the period when a custodian is unable to take custody of crypto assets, advisers have to rely on self-custody. If an adviser is not permitted to self-custody a crypto asset in those circumstances, investors lose out on an investment opportunity and the adviser is required to neglect its fiduciary duty to its investors.

b. The adviser reasonably safeguards the assets from loss, theft, misuse, misappropriation, or the adviser's financial reverses, including the adviser's insolvency.

There are many safeguards that have been developed to self-custody crypto assets. For example, one method used in the industry is on-premises cold storage with enterprise level security and key management. Other methods include (1) segregation of duties, including multi-signature wallets, to ensure that no one individual or device can initiate or finalize a cryptographic operation; (2) disclosing to clients that certain assets are not with a qualified custodian to provide notice and obtain implicit consent; (3) an annual audit by a Public Company Accounting Oversight Board registered firm, which includes a demonstration of control and review of internal procedures; (4) using secure keygen technology; (5) clearly identifying and segregating client assets, including a demonstrable audit trail of all purchases, transfers, and sales, whether on a blockchain explorer or otherwise; (6) shard storage; and (7) other robust administrative, technical, and physical safeguards consistent with industry standards and practices. Firms often maintain these safeguards in a custody policy and reassess risk factors on a yearly basis or even as certain events occur.

c. An independent public accountant, pursuant to a written agreement between the adviser and the accountant: (i) verifies any purchase, sale, or other transfer of beneficial ownership of such assets promptly upon receiving notice from the adviser of any purchase, sale, or other transfer of beneficial ownership of such assets; and (ii) notifies the SEC within one business day upon finding any material discrepancies during the course of performing its procedures.

[16] We note that a qualified custodian should not be considered "available" if it cannot provide a full suite of custodial services beyond simply holding assets and facilitating transactions. To be "available" in the context of crypto assets means that a custodian must be able to accommodate critical on-chain activities such as staking, voting, and other network participation.

This condition works equally well in the context of crypto assets. However, we respectfully urge the Commission to revise the condition to allow an independent public accountant to verify purchases and sales on a regular periodic basis, such as quarterly. The requirement to do so "promptly" does not seem justified and could be costly.

d. The adviser notifies the independent public accountant engaged to perform the verification of any purchase, sale, or other transfer of beneficial ownership of such assets within one business day.

While we would suggest that the one business day notification requirement is unnecessarily stringent and the protective nature of the condition works equally well with a longer notification period, the condition itself works with equal force for crypto assets as it does for privately offered securities or physical assets.

e. The existence and ownership of each of the client's privately offered securities or physical assets that is not maintained with a qualified custodian are verified during the annual surprise examination or as part of a financial statement audit.

Again, this condition works equally well in the context of crypto assets.

We strongly believe new Rule 223-1 should be revised to allow registered advisers to provide professional management of crypto assets for which there is currently no qualified custodian available. As drafted, new Rule 223-1 unfairly limits the ability for clients of registered advisers (and the investors in private funds they manage) to invest in crypto assets for which there is no available qualified custodian. This also places registered advisers managing private funds at a distinct disadvantage to exempt reporting advisers (who would not be subject to new Rule 223-1) managing a similar but smaller private fund.

IV. The definition of qualified custodian set forth in Rule 223-1, which is the same as under the current custody rule, should remain as drafted and not be narrowed.

As currently drafted, new Rule 223-1 maintains the Custody Rule's definition of qualified custodian. Among other entities, that definition includes a "bank as defined in section 202(a)(2) of the Advisers Act (15 U.S.C. 80b–2(a)(2))."[17] While keeping the existing definition

[17] The definition of "bank" under the Advisers Act includes state-chartered trust companies, including non-depository trust companies that are regulated as banks under state law.

of qualified custodian, Rule 223-1 imposes a number of new operational and structural protections with which all qualified custodians would need to comply.[18]

In the Proposal, the Commission has asked a series of questions regarding the narrowing of the definition of qualified custodian, most particularly in the context of state-chartered trust companies that are not also depository institutions with deposits insured by the Federal Deposit Insurance Corporation ("FDIC") under the Federal Deposit Insurance Act or otherwise regulated by the FDIC or the other federal prudential banking regulators. The Proposal also solicits comment on whether the new operational protections should only be applied to state-chartered institutions that are not regulated by the FDIC or other federal prudential banking regulators.

We believe that the qualified custodian definition should not be tightened to require state-chartered trust companies to be Federal Reserve or FDIC member banks.[19] We believe that investors in our private funds benefit by allowing competition in and the development of newer entrants in the custody arena, particularly in the context of alternative assets, including crypto assets. Imposing such a requirement could further thwart competition in this space, where options are already limited as a result of guidance from prudential regulators cautioning banks under their supervision to not allow purported risks from the crypto asset market to migrate into

[18] Specifically, new Rule 223-1 would require all qualified custodians to (1) hold client assets in bankruptcy remote accounts designed to protect those assets from the custodian's creditors in the event of the custodian's bankruptcy or insolvency; (2) exercise due care and implement appropriate measures to safeguard advisory clients' assets; (3) indemnify advisory clients when the custodian's negligence, recklessness, or willful misconduct results in that a client's loss; (4) maintain their responsibilities to advisory clients in connection with sub-custodial arrangements; (5) clearly identify each advisory client's assets and segregate each advisory client's assets from its proprietary assets; (6) maintain advisory clients' assets free of liens in favor of the custodian unless authorized in writing by the client; (7) keep certain records relating to client assets; (8) cooperate with independent public accountants' efforts to assess the custodian's safeguarding efforts; (9) provide periodic custodial account statements directly to advisory clients; (10) evaluate periodically their internal controls relating to custodial practices for effectiveness; and (11) provide in custodial agreements an investment adviser's agreed upon level of authority to transact in the advisory client's account. Proposal at 14,683, 14,692.

[19] There is presently only one state-chartered entity that was able to obtain a federal charter (Anchorage). *See* Leo Schwartz, Crypto bank Protego didn't meet all requirements for national trust charter, OCC says, Fortune (Mar. 17, 2023) available at https://fortune.com/crypto/2023/03/17/crypto-bank-protego-didnt-meet-requirements-for-national-trust-charter-occ-says/. Other firms have tried to obtain a federal charter but have been unfairly denied access to the Federal Reserve system without much explanation (Protego, Custodia and Paxos). Setting this federal standard would be close to impossible to meet and unnecessary, as many of the requirements for qualified custodians under state laws are already in existence. For example, *see* New York State Department of Financial Services Virtual Currency Guidance (Apr. 28, 2022) available at https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics. Moreover, the Commission has failed to justify a departure from well-settled law recognizing state trusts as qualified custodians (*see* 17 C.F.R. § 275.206(4)-2(d)(6); 15 U.S. Code § 80b–2 (a)(2)(C), a "qualified custodian" includes a "bank," which is defined to include 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.")

the banking system[20] and guidance like SAB 121, which has also resulted in fewer entities willing to custody crypto assets.

We also believe that the new conditions proposed by the Rule 223-1, applicable to all qualified custodians, should be evenly applied to all qualified custodians under Rule 223-1. The new structural protections of Rule 223-1 are additional and useful protections when custodial services are provided by even the largest of the federally regulated banks. Limiting their applicability to only non-FDIC regulated state entities would deny the benefit of those protections to investors in private funds custodied at the largest federally regulated banks.

CONCLUSION

The Firms appreciate the attention to which the SEC has taken to modernize the Custody Rule, and we respectfully encourage the SEC to consider our comments, as well as those of our peers, to revise the Proposal. The safeguarding of crypto assets is a vital concern for our industry, but it must be properly balanced against the real concern of stifling emergent technology and innovation. We welcome discussing our comments with the SEC and its staff to work toward a practical regulatory regime that encourages the growth of this nascent industry while protecting investors.

Respectfully submitted,

Bain Capital Crypto, LP

By:

Tuongvy Le

Tuongvy Le
Partner and Head of Regulatory & Policy

[20] Crypto-Assets: Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), available at https://www.occ.treas.gov/news-issuances/bulletins/2023/bulletin-2023-1.html; *see also* How U.S. Regulators Are Choking Crypto, Wall St. J. (Mar. 27, 2023), available at https://www.wsj.com/articles/us-regulators-choke-point-for-crypto-blockchain-occ-framework-backdoor-fdic-banks-warning-8b426152.

Dragonfly Digital Management, LLC

By:

Jessica Furr
Jessica Furr
Associate General Counsel

Electric Capital Partners, LLC

By:

Emily Meyers
Emily Meyers
General Counsel

Haun Ventures Management LP

By:

James Rathmell
James Rathmell
General Counsel

Ribbit Management Company, LLC

By:

Jessi Brooks
Jessi Brooks
Chief Compliance Officer and Regulatory Counsel