COMMITTEE ON CAPITAL MARKETS REGULATION

May 8, 2023

Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

VIA ELECTRONIC MAIL: rule-comments@sec.gov

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

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "Committee") is grateful for the opportunity to provide comments to the U.S. Securities and Exchange Commission (the "SEC") on its proposed rule under the Investment Advisers Act of 1940 (the "Advisers Act")[1] regarding the safeguarding and custody of client assets by investment advisers (the "Proposal").[2]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in two parts. Part I describes certain significant changes that the Proposal would make to the custody requirements for investment advisers. Part II then assesses the proposed changes and their underlying policy rationale. We find that the Proposal would institute wide-ranging, impracticable, and extremely costly changes to custody-related practices. The SEC does not identify any policy rationale for these changes, because there is none. To even attempt to comply with the Proposal, registered investment advisers would need to completely restructure their businesses. Indeed, many of the Proposal's requirements would be impossible to comply with and would effectively exclude the clients of registered investment advisers from entire asset classes and from foreign markets completely. The Proposal does not consider or quantify these costs. The Proposal would moreover fail to address the gap in custody requirements that exists with respect to cryptoassets. The Committee calls on the SEC to withdraw the Proposal and instead to work with other regulators to propose tailored reforms that are aimed specifically at addressing any identified gaps in existing regulatory frameworks.

[1] 15 U.S.C. § 80b–1 *et seq*.

[2] Securities & Exchange Commission ["SEC"], *Safeguarding Advisory Client Assets*, 88 FR 14,672 (Mar. 9, 2023) https://www.federalregister.gov/documents/2023/03/09/2023-03681/safeguarding-advisory-client-assets [hereinafter "Proposing Release" or "Proposed Rule"].

I. Overview of the Proposal

Subpart (1) below briefly summarizes the custody rules that presently apply to registered investment advisers. Subpart (2) then reviews how the Proposal would change these rules.

1. Current custody requirements for registered investment advisers

Rule 206(4)-2 (the "Custody Rule")[3] requires registered investment advisers ("RIAs") that have custody of client funds or securities to implement a set of controls designed to protect those client assets from loss, misuse, misappropriation, or being subject to an adviser's financial reverses. The Custody Rule thus provides that an RIA that has custody of funds and securities must maintain those funds and securities with a "qualified custodian" in a separate account in the name of the investor or in accounts that contain only the adviser's clients' funds and securities.[4] A "qualified custodian" must be an FDIC-insured bank or savings association, a broker-dealer, a futures commission merchant, or a foreign financial institution that meets criteria that the Custody Rule specifies.[5] The RIA may itself function as the qualified custodian if it falls into one or more of these categories; otherwise it must engage another entity as the qualified custodian to provide the required custody protections on the RIA's behalf, in which case the Custody Rule continues to treat the RIA as having custody of the client assets for regulatory purposes.

The Custody Rule does not apply to client assets that are not securities or cash such as non-security derivatives (e.g., commodities futures) or hard assets (e.g., real estate). It also does not apply to cryptoassets that are neither "securities" nor "funds," though the Proposal asserts that most cryptoassets are "likely to be funds or . . . securities covered by the current rule."[6] Privately offered securities are also generally excepted because, as the Proposal explains, they are "less likely to be stolen by a third party or simply lost" due to "the need to obtain the consent of the issuer or other securities holders prior to any transfer of ownership."[7]

The Custody Rule also does not apply if the RIA's client is a mutual fund or other public investment fund registered under the Investment Company Act of 1940 (a "registered fund"), since separate rules apply to custodians for registered funds.[8]

2. How the Proposal would modify the Custody Rule

The Proposal explains that since the Custody Rule was last amended in 2009 "industry developments" including "changes in technology, advisory services, and custodial practices" have resulted in increased risks of "loss, theft, misuse, or misappropriation" that may not be "fully addressed" under the current rule.[9] However, the Proposal provides no evidence that qualified custodians have failed in their obligations to properly custody RIA client assets or that a broad remaking of the Custody Rule is otherwise necessary. In remarks introducing the Proposal, SEC

[3] 17 CFR § 275.206(4)-2.
[4] *Id.* § 275.206(4)-2(a).
[5] *Id.* § 275.206(4)-2(d)(6)(i)-(iv).
[6] Proposing Release at 14,676.
[7] *Id*. at 14,704.
[8] *Id*. at 14,693, n.152 (citing 17 CFR § 270.17f-4).
[9] *Id.* at 14,674-75.

Chair Gensler highlighted in particular recent incidents in the cryptoasset markets where cryptoasset trading platforms failed to properly custody customer assets as a factor necessitating the Proposal[10] – but these were not failures of qualified custodians. The Proposal nonetheless claims that it is necessary to significantly modify the Custody Rule.

We focus on five major changes that the Proposal would make to the current Custody Rule. First, the Proposal would require all client assets of which the RIA has custody to be placed with qualified custodians including non-security derivatives, commodities, and privately offered securities that are not presently covered by the Custody Rule, many of which cannot possibly be held in accordance with the rule's requirements.[11] Second, it would introduce unworkable requirements for the use of foreign financial institutions as qualified custodians.[12] Third, the Proposal would require bank and savings associations acting as qualified custodians for RIAs to maintain custodied cash in bankruptcy-remote accounts.[13] Presently, such banks treat custodied cash as a cash deposit that is not bankruptcy remote. Fourth, the Proposal would require qualified custodians to segregate all RIA client assets from the qualified custodian's proprietary assets, which would effectively prohibit standard prime brokerage arrangements.[14] And fifth, it would require RIAs to seek specified contractual terms and assurances from their custodians and monitor their custodians to ensure the safekeeping of client assets.[15]

II. Analysis of the Proposal

In Part II we identify six significant flaws with the Proposal.

1. Expanding the Custody Rule to cover all client assets would be impossible for RIAs to comply with, exclude RIA-advised investors from entire asset classes, and exceed the SEC's statutory authority.

The Proposal would expand the Custody Rule to cover all client assets, including those that are not securities. This would include commodities-linked derivatives, physical assets, and any other client assets. The Proposal would moreover explicitly require that the qualified custodian maintain "possession or control" of the assets, unless an exception is available.[16] The application of the Custody Rule to these non-security assets would create an impossible compliance burden for RIAs, because in many cases there is no possible way that a qualified custodian could hold such assets in accordance with the Proposal.

Non-security derivatives and physical assets are only two of the significant instances in which compliance with the Proposal would be impossible. A derivative is fundamentally only a set of contractual rights. The SEC provides no analysis or explanation regarding how a qualified custodian could maintain possession or control of such instruments or how such instruments

[10] SEC, Chair Gary Gensler, *Statement on Proposed Rules Regarding Investment Adviser Custody* (Feb. 15, 2023), https://www.sec.gov/news/statement/gensler-statement-custody-021523.

[11] Proposed Rule at 14,677.

[12] *Id*.

[13] *Id*. at 14,678.

[14] *Id*.

[15] *Id*. at 14,677.

[16] Proposed Rule § 223–1(d)(8).

present any credible risk of being lost or misappropriated by an RIA. For example, bilateral over the counter ("OTC") derivatives (uncleared) are agreements between two parties. It is unclear if the Proposal would require third-party qualified custodians to become a party to these agreements, whether qualified custodians would agree to such a role, or whether a swap counterparty itself would agree to the introduction of a third party with the authority to prevent transfers of the contract. Practical difficulties aside, the Proposal provides no evidence, and there is little reason to believe, that the introduction of qualified custodians to these bilateral agreements will provide any additional investor protections. Instead, this requirement is likely to increase costs and operational difficulties.

Moreover, the definition of "assets" includes collateral posted in connection with OTC derivatives.[17] The Proposal's requirement that qualified custodians segregate assets from the custodian's own assets and liabilities would effectively prohibit the rehypothecation of collateral by broker-dealer custodians, including variation margin and non-regulatory initial margin. Segregation of variation margin and non-regulatory initial margin would result in the re-pricing of virtually all bilateral OTC derivatives where an RIA client is a party, to the client's detriment. Required segregation of this margin would bring with it increased transaction costs and would materially decrease client returns. This would also constitute a significant departure from the uncleared swap margin rules implemented pursuant to the Dodd-Frank Act.[18]

The Proposal would also negatively impact the market for futures and cleared derivatives. While the Proposal would expand the scope of the Custody Rule to cover these instruments, the Proposal did not make corresponding changes to the futures commission merchant category in the definition of qualified custodian, where futures commission merchants are only qualified custodians "with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon."[19] As a result, a futures commission merchant would not meet the definition of qualified custodian with respect to commodity futures and derivatives. Even if the Proposal expanded the definition to cover a futures commission merchant's commodity futures and derivatives business, it is unclear whether any futures commission merchant could agree to the Proposal's written agreement provisions in compliance with its own regulatory requirements under the Commodity Exchange Act.[20]

While the Proposal purports to recognize that in some cases it will not be possible for a qualified custodian to "possess" or "control" certain physical assets and private securities, the alternative compliance proposed by the SEC is unworkable. For physical assets and private securities that an RIA determines it cannot hold with a qualified custodian, the Proposal would require that an adviser enter into a written agreement with an independent public accountant, and that the public accountant affirmatively "verify" any purchase, sale or other transfer of beneficial ownership of such assets "promptly."[21] This requirement would introduce significant costs and frictions into well-established markets, impose significant costs on RIA clients, and is likely unworkable in

[17] Proposing Release at 14,679.

[18] 17 C.F.R. Parts 23 and 140.

[19] Proposed Rule § 223–1(d)(10)(iii).

[20] 7 U.S.C. Chapter 1.

[21] Proposing Release at 14,708.

certain markets. For example, certain commodities trade frequently throughout the day. To the extent a fund advised by an RIA trades commodities often, it is unclear how an independent accountant would be expected to "promptly" verify such transactions, and doing so may require specialized training or expertise. To the extent prompt verification is even possible, this requirement would impose significant costs on RIA clients. Many of these markets are already subject to extensive regulation, such as by the Federal Energy Regulatory Commission, which has in place comprehensive requirements regarding interstate possession and control of assets within its purview. The Proposal does not provide answers to these fundamental questions, and will interfere with well-functioning and well-regulated markets.

To the extent RIAs are unable to hold an asset class in accordance with the Custody Rule, as they frequently would be, RIA-advised funds and other RIA-advised investors would be unable to invest in those assets. This would impose massive costs on those investors. Moreover, as of Q4 2022, RIA-advised hedge funds alone accounted for $5.15 trillion in total net asset value.[22] Given their substantial size, to the extent they are unable to participate in and must divest from the market for certain asset classes, the underlying U.S. markets for those assets are likely to experience major disruptions, including in the form of reduced liquidity and increased price volatility. The Proposal would thus produce costs across the entire market. However, the Proposal does not even consider these effects, let alone attempt to quantify their costs.

In addition, the Proposal's argument for the SEC's jurisdiction to expand the Custody Rule to non-securities is wholly inadequate. The Proposal cites Section 411 of the Dodd-Frank Act, which added Section 223 to the Advisers Act, which requires RIAs to "take steps to safeguard client assets over which such adviser has custody."[23] The Proposal claims that because Section 223 does not refer specifically to "securities," Congress authorized the SEC to "prescribe rules requiring advisers to take steps to safeguard all client assets" including those that are not securities.[24] However, under the major questions doctrine, for an agency to assert rulemaking authority to change a statute from "one sort of scheme of . . . regulation into an entirely different kind" the agency must point to "clear congressional authorization."[25] The Proposal argues Congress expanded the SEC's jurisdiction to cover all assets, including those that are the responsibility of other regulators (e.g., commodities derivatives, which are the responsibility of the CFTC) without explicit authorization but rather by implication. Such an argument conflicts with the major questions doctrine.

2. The Proposal's requirements for foreign financial institutions would prevent RIA-advised investors from investing in non-U.S. markets.

The Custody Rule presently permits RIAs to use foreign financial institutions ("FFIs") as qualified custodians. The ability to use FFIs as qualified custodians is crucial for RIA-advised funds and other RIA-advised investors to access foreign markets, because local laws and other limitations often prevent U.S. banks or broker-dealers from custodying assets in foreign jurisdictions.

[22] SEC Form ADV Data.
[23] 15 U.S.C. § 80b–18b.
[24] Proposing Release at 14,674.
[25] West Virginia v. EPA, 59 U.S. __ (2022).

The Proposal would redefine FFI such that to use an FFI as a qualified custodian, the RIA must determine that both the RIA and the SEC are "able to enforce judgments, including civil monetary penalties" against the FFI and that the customer's assets would be "protect[ed]" from the creditors of the FFI in the event of the FFI's insolvency.[26] With respect to each of these requirements, the RIA would need to make a separate assessment under the law of each jurisdiction in which it uses an FFI as a qualified custodian. The mere attempt to comply with these requirements would result in significant legal costs. But even then, each of these requirements represents an impossible compliance burden, in that there is no way that an RIA could determine the cross-border enforceability of a hypothetical legal judgment *and* the outcome of a hypothetical insolvency proceeding (which even in established jurisdictions can be unclear) under foreign law with sufficient certainty. Compounding the complete impracticability of these requirements is the additional criterion that the FFI must have the "requisite financial strength to provide due care for client assets."[27] The Proposal does not explain how RIAs could reasonably be expected to apply such a vague requirement. The Proposal's new requirements would thus force an RIA to incur unacceptably high legal risks and compliance costs any time its client invests in a foreign market. Most RIAs would therefore be unable to accommodate foreign investments by their clients, such that RIA-advised funds and other RIA-advised investors would be largely unable to invest in foreign markets. The Proposal does not even consider that it would have the effect of shutting a significant contingent of U.S. investors out of foreign markets, let alone attempt to quantify the resulting costs. More generally, the Proposal does not consider or analyze the complexities and ambiguities of the unprecedented requirements it seeks to impose, and leaves commenters to do so within a 60-day comment period.

3. The requirement that custodied cash be held in bankruptcy remote and segregated accounts is unnecessary and would interfere with banks' intermediation function.

Presently, banks acting as custodians of client assets treat custodied cash in the same way as they do other cash deposited at the bank. Custodied cash is simply a cash deposit. Custodied cash therefore increases a bank's deposit base and enables the bank to fund additional assets, such as loans or securities, with the cash. However, the Proposal would prevent custodians of cash for RIAs from treating such cash as a deposit and instead would require that cash to be held in a segregated account.[28] As a result, the balance sheet of bank custodians would shrink and so would their ability to act as a lender or dealer.

The Proposal asserts that this change will provide further protection for the cash of RIA clients in the event of a failure of a custodian.[29] The Proposal asserts it would do so because segregated cash assets would be bankruptcy remote whereas RIA clients could presently be exposed to losses from uninsured cash deposits.[30]

However, the Proposal has failed to substantiate the need for additional protections for custodied cash. Indeed, bank capital and liquidity requirements guard against the failure of a bank or savings

[26] Proposed Rule § 223–1(d)(10)(iv)(A), (D).

[27] *Id*. § 223–1(d)(10)(iv)(E).

[28] *Id*. § 223–1(d)(10)(i).

[29] Proposing Release at 14,695.

[30] *Id*.

association and, even if a bank becomes insolvent, customers' cash deposits are protected by FDIC insurance up to the $250,000 limit.[31] The SEC identifies no compelling rationale for banks and savings associations to segregate customer cash when these prudential requirements already exist. Even if there have been recent shortfalls in resiliency in the banking sector, it is the responsibility of banking regulators to address them, not the SEC.

The Proposal also fails to consider or quantify the costs of this requirement. Banks' and saving associations' inability to deploy custodied cash subject to the Proposal to make loans would negatively affect the returns from providing custody services to RIAs, thus making such custody services for RIAs less available or more expensive. Additionally, banks use customer deposits, including custodied cash, to provide a wide range of services to their clients beyond lending, from basic services like overdraft protection[32] to facilitating customer equity trading. The ability of RIA bank custodians to provide such services would also be restricted by the Proposal. Moreover, custodians are currently able to provide cash management services to the client. The Proposal's segregation requirement would prevent this and instead require that the custodian deposit the client's cash at another bank. This would prevent the custodian from providing cash management services to the client. And it would also not reduce credit risk to the client – to the extent there is any – but rather simply transfer the credit risk from the custodian to the bank where cash must now be deposited.

4. The requirement that custodied cash be held in segregated accounts would interfere with prime brokerage agreements.

The requirement that custodied cash be held in segregated accounts would prevent RIA-advised investors from agreeing to rehypothecation as part of their prime brokerage agreements and would require the amendment or abrogation of such investors' existing prime brokerage agreements that permit rehypothecation. Prime brokerage agreements allow RIA-advised investors to obtain valuable services such as margin loans and securities lending. Brokers typically cover the cost of providing these services by obtaining the right to rehypothecate the client's assets. Because rehypothecation involves the use of client assets as collateral for new loans by the prime broker, it is not possible if the client's assets are confined to a bankruptcy-remote account. We note that Exchange Act Rules expressly permit the rehypothecation of margin securities: While Exchange Act Rule 15c3-3 requires fully paid for securities to be segregated and kept within a broker-dealer's possession and control, margin securities are permitted to be de-segregated and rehypothecated to fund cash margin loans to customers.[33] In the absence of rehypothecation, prime brokers would need to recoup the cost of the services they provide by other means such as charging prime brokerage clients higher fees. Rehypothecation also increases market liquidity. The Proposal however does not consider or quantify these costs.

[31] *See, e.g.*, USBANK, Bank vs. Brokerage Custody (Nov. 21, 2022), https://www.usbank.com/financialiq/plan-your-growth/find-partners/bank-vs-brokerage-custody.html

[32] CONSUMER FINANCE PROTECTION BUREAU, Understanding the Overdraft "Opt-in' Choice (Jan. 19, 2027) https://www.consumerfinance.gov/about-us/blog/understanding-overdraft-opt-choice/.

[33] 17 C.F.R. § 240.15c3-3.

5. The new contractual provisions and assurances that the Proposal requires RIAs to obtain from qualified custodians would create an extremely costly and completely unnecessary compliance burden for advisers, particularly smaller advisers.

The contractual provisions and "reasonable assurances" that the Proposal would require RIAs to obtain from their clients' qualified custodians represent a substantial departure from current industry practice. This departure will impose significant costs on market participants that the Proposal does not consider. Most fundamentally, the contractual provisions and assurances that the Proposal requires would be so inconsistent with existing market practices and impose such impracticable obligations on qualified custodians (e.g., the requirement that the qualified custodian assume liability for the failures of central securities depositories, which qualified custodians must use and over which they have no control) that qualified custodians are unlikely to ever agree to them. Rather than accept such unprecedented obligations, qualified custodians would instead concentrate their business on other market participants (not RIAs). This would reduce, if not eliminate, the supply of qualified custodial services available to RIA clients.

The mere attempt to negotiate the required contracts and assurances would impose massive legal and other transaction costs on RIAs and qualified custodians, many of which are likely to be passed on to RIA clients. RIAs would also need to negotiate amendments to the agreements governing their clients' trading relationships, since these agreements also typically include custody provisions, further increasing these costs. And even if an RIA were able to obtain the required provisions and assurances from a qualified custodian, the Proposal would still impose an unworkable compliance burden. Notably, as part of the "reasonable assurances" requirement, the Proposal "will require due diligence and periodic monitoring" by the RIA of the custodian.[34] This monitoring burden will be complex, since "the appropriateness of the measures required to safeguard assets varies depending on the asset."[35] As Commissioners Peirce and Uyeda both noted in their remarks on the Proposal, these costs are likely to represent a disproportionate burden for smaller advisers, who benefit from fewer economies of scale.[36] Once again, the Proposal fails to consider or quantify the magnitude of these costs.

6. The Proposal would not address the current lack of adequate custody protections with respect to cryptoassets.

The cryptoasset that currently dominates the U.S. and global cryptoasset markets – bitcoin – is generally understood not to constitute a "security" under U.S. securities law. Indeed, even SEC Chair Gensler has acknowledged that bitcoin is not a security.[37] Bitcoin is therefore not covered by the current Custody Rule. The Proposal makes clear that it would cover all cryptoassets, regardless of whether they constitute securities, and would thus require RIAs to ensure, for example, that any bitcoin held in custody for an RIA be held by a qualified custodian.

[34] Proposed Rule at 14,746.
[35] *Id.* at 14,693.
[36] SEC, Commissioner Hester M. Peirce, *Statement on Safeguarding Advisory Client Assets Proposal* (Feb. 15, 2023), https://www.sec.gov/news/statement/peirce-statement-custody-021523#_ftn2; SEC, Commissioner Mark T. Uyeda, *Statement on Proposed Rule Regarding the Safeguarding of Advisory Client Assets* (Feb. 15, 2023), https://www.sec.gov/news/statement/uyeda-statement-custody-021523.
[37] Andre Beganski, *SEC Chair Gensler Again Says Bitcoin Is Not a Security. What About Ethereum?* DECRYPT (June 27, 2022), https://decrypt.co/103926/sec-chair-gensler-bitcoin-not-security-what-about-ethereum.

SEC Chair Gensler suggested in a statement introducing the Proposal that this expansion to non-security cryptoassets is intended to address the current lack of custody protections in cryptoasset markets. He referred specifically to the case of customer cryptoassets held on cryptoasset trading platforms, stating that "[r]ather than properly segregating investors' crypto, these platforms have commingled those assets with their own crypto or other investors' crypto" and that "[w]hen these platforms go bankrupt—something we've seen time and again recently—investors' assets often have become property of the failed company, leaving investors in line at the bankruptcy court."[38]

Chair Gensler is correct that the lack of a qualified custodian requirement with respect to cryptoasset trading platforms has placed customers at risk of loss and theft and that certain platforms have failed to segregate customer cryptoassets in a manner that shielded those assets from the platform's creditors - as exemplified most prominently by the failure of the major cryptoasset trading platform FTX. However, it is unlikely that the Proposal would offer significant protection against the recurrence of similar situations, and the SEC offers no meaningful evidence to support the view that it would.

Indeed, the Proposal would only apply to cryptoassets held through RIA accounts, so it would not apply to cryptoassets that customers hold directly with cryptoasset trading platforms without the involvement of an RIA. The Proposal provides no quantitative evidence of the extent to which customer assets held on cryptoasset trading platforms are associated with the accounts of RIA clients.

In fact, there is evidence that many of FTX's customers traded and held their assets on the platform without the involvement of an RIA.[39] These investors would have received no protection from the Proposal. The same is true of the many customers of other cryptoasset trading platforms still in operation today who use those platforms without the involvement of an RIA. The SEC makes no attempt to quantify how many customers or cryptoassets this includes.[40]

Rather than broadly rewriting the custody rules for RIAs, a far more effective and efficient way of addressing the lack of custody protections in cryptoasset markets would be to place a qualified custodian requirement directly on cryptoasset trading platforms. In a recent statement the Committee expressed its support for such a requirement.[41]

However, in the same statement, the Committee also detailed how the SEC's SAB 121 accounting guidance has made it largely impracticable for banks and broker-dealers to act as qualified custodians for cryptoassets. SAB 121 does so by requiring public reporting banks and broker-

[38] SEC, Chair Gensler, *supra* note 10.

[39] *See, e.g.*, Matthew Goldstein, *Ordinary Investors Who Jumped Into Crypto Are Saying: Now What?* NEW YORK TIMES (Dec. 5, 2022) https://www.nytimes.com/2022/12/05/business/cryptocurrency-investors-ftx-blockfi.html.

[40] Jess Hamilton, *SEC Proposal Could Bar Investment Advisers From Keeping Assets at Crypto Firms* COINDESK (Feb. 15, 2023) https://www.coindesk.com/policy/2023/02/15/sec-proposal-could-bar-investment-advisers-from-keeping-assets-at-crypto-firms/ ("When asked whether the regulator had gathered any data to illustrate the scale of digital assets tied to registered investment adviser clients, officials at the agency said they hadn't.").

[41] COMMITTEE ON CAPITAL MARKETS REGULATION, *Issues with Crypto Asset Custody and SEC Staff Accounting Bulletin No. 121* (Dec. 6, 2022), https://capmktsreg.org/wp-content/uploads/2022/12/CCMR-Statement-SEC-Staff-Accounting-Bulletin-121-Issues-in-Crypto-Asset-Custody-12.06.22.pdf.

dealers to place custodied cryptoassets on their balance sheets and thereby incur significant capital costs from doing so.[42] The SEC's own guidance thus currently stands in the way of an effective market solution to the lack of qualified custodial services in cryptoasset markets and would continue to do so even if the Proposal is enacted.

The impediment posed by SAB 121 is compounded by bank regulators' skepticism of banks providing custody services for cryptoassets, as expressed in the January 2023 joint statement of the Federal Reserve, Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.[43] Indeed, the Proposal would compel RIAs to place customer cryptoassets with qualified custodians, but if banks and broker-dealers, the principal providers of such services, are effectively unable to do so because of regulatory impediments, RIAs will to a large extent not be able to comply. This would potentially result in RIAs simply not offering cryptoasset-related services to their clients. In this way, the Proposal may function not as an investor protection but as a *de facto* bar on cryptoasset-related services by RIAs and to cause more investors to hold cryptoassets outside their RIA accounts, beyond the scope of the Proposal.

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[42] SEC, *Staff Accounting Bulletin No. 121* (modified Apr. 8, 2022), https://www.sec.gov/oca/staff-accounting-bulletin-121.

[43] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, OFFICE OF THE COMPTROLLER OF THE CURRENCY, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

III. Conclusion

The Proposal presents no evidence or any compelling policy rationale for a need to fundamentally remake the custody rules as they apply more broadly. The Proposal however would result in extremely costly and unnecessary disruptions to the custody of *all* RIA assets, shut out RIA-advised investors from major asset classes and foreign markets, and disrupt the underlying markets for the assets in which RIA-advised investors invest. While there is a need for regulators to adopt the reforms necessary to facilitate the provision of qualified custodial services in cryptoasset markets, the Proposal does nothing to further this aim. The Committee calls on the SEC to withdraw this Proposal and instead to propose tailored reforms that are aimed specifically at addressing the immediate and significant problem of the lack of a qualified custodian requirement in cryptoasset markets.

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Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

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