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Submitted electronically through (https://www.sec.gov/rules/submitcomments.html)

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

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

Dear Ms. Countryman,

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission ("SEC" or "Commission") on its proposed new rule under the Investment Advisers Act of 1940 (the "Advisers Act") to address how investment advisers safeguard client assets (the "Proposal").[2]

We fully support the Commission in its review of how investment advisers safeguard client assets. We believe sound regulation and effective oversight procedures are vital to ensure client assets are properly safeguarded. This oversight is also a critical part of the client-adviser relationship and establishes a level of confidence that clients rely upon when entrusting their hard-earned assets with an adviser. This is the foundation on which Fidelity has operated its business for more than 76 years. More than 40 million individual investors and more than 3,700 clearing and custody firms trust us to protect their $10.3 trillion in assets under administration from loss, misuse, or misappropriation. We believe investors benefit from current Rule 206(4)-2 under the Investment Advisers Act of 1940 ("the custody rule").[3]

I. EXECUTIVE SUMMARY

Fidelity and the SEC share a common commitment to ensuring customers' assets are safeguarded. However, we believe that the new requirements set forth in the Proposal, while well-intentioned, are not only unnecessary, but will create confusion, limit investor choice, and

[1] Fidelity is one of the world's largest providers of financial services, including investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 40 million individual investors, 23,000 employers and more than 3,700 clearing and custody firms. Fidelity submits this letter on behalf of Fidelity companies that are "qualified custodians" or registered investment advisers or are otherwise impacted by the Proposal including National Financial Services LLC, FIAM LLC and Fidelity Digital Asset Services, LLC.

[2] *See* Safeguarding Advisory Client Assets, Release No. IA-6240, RIN 3235-AM32 (February 15, 2023) ("Proposing Release"), available at https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[3] *See* Custody of Funds or Securities of Clients by Investment Advisers available at https://www.sec.gov/rules/final/ia-2176.htm.

increase the costs ultimately borne by retail investors. Specifically, limiting digital asset qualified custodians to federally regulated institutions would artificially and unnecessarily shrink the market for, and quality of, custodial services without generating safety benefits for clients.

- ***Fidelity Shares the SEC's Goal of Properly Safeguarding Client Assets.*** This protection has been a critical element of Fidelity's business for 76 years and we remain steadfast in our responsibility for investor's hard-earned investments.
- ***The Current Regulatory Framework Under Rule 206(4)-2 Appropriately Protects Investors.*** The current structure affords investors the proper amount of protection while allowing the financial industry flexibility to provide new services and maintain investor confidence.
- ***The Proposal Introduces Unnecessary and Costly Requirements.*** Many of the Proposal's requirements are unnecessary, unworkable and in some circumstances duplicative in nature to current regulatory requirements.
- ***The Required Written Agreements Between Investment Advisers and Qualified Custodians Do Not Benefit Investors.*** Given the robust regulation already in place under Rule 206(4)-2, an additional written agreement will not offer any meaningful new protections for investors. The new requirement could limit investor choice and increase investor costs. The SEC also significantly underestimates the amount of time required to negotiate each written agreement.
- ***The SEC Has Not Properly Analyzed the Current Market to Confirm All Requirements Can be Met.*** Specifically, the Proposal offers no data or analysis on the number of Public Company Accounting Oversight Board ("PCAOB") audit firms and the number of independent public accountants to determine if there are a sufficient number of firms to support every asset that cannot be maintained by a qualified custodian.
- ***The Proposal's Expansion of the Term "Custody" to Include Discretionary Trading Authority Introduces Confusion.*** Qualified custodians currently review each transaction regardless of settlement process, and the Proposal's inclusion of discretionary trading authority should be clarified as it relates to retail managed accounts and current no action relief.
- ***Fidelity Supports the Proposal's View that Qualified Custodians Continue to Include State-Chartered Trust Companies.*** State-chartered trust companies are among the leading providers of custody services for digital assets, and we appreciate the Commission's recognition of their important role.
- ***The SEC Should Incorporate Implementation Periods into Rulemakings that Will Not Destabilize Market Functions.*** We do not believe moving forward with the Proposal is in the best interest of investors. However, we would like for the Commission to broadly recognize the many complex compliance and operational changes currently being proposed or adopted by the SEC, and to incorporate longer implementation periods to ensure market participants of all sizes can properly build,

test, and secure systems before rolling out changes that could lead to market instability and investor harm.

II. WRITTEN AGREEMENTS AND ASSURANCES ARE UNNECESSARY AND HARMFUL TO INVESTORS BY LIMITING CHOICE AND INCREASING COSTS

The Proposal will require drafting, negotiating, re-executing and organizing the custodian relationships for the vast majority of the 15,000 SEC-registered investment advisers — essentially all registered investment advisers that provide any kind of portfolio management. The effect of the Proposal on investment advisers may result in the limiting of services, an increase in costs, and a diminished client experience. Further, it is likely that certain smaller qualified custodians could narrow the scope of services they provide to registered investment advisers or exit the custody business altogether, resulting in decreased competition among qualified custodians and increased concentration of services and systemic risk. Custodial costs will increase, thus increasing investor costs. These results are in direct contrast with the SEC's mission of protecting investors, maintaining fair, orderly, and effective markets, and facilitating capital formation.

Moreover, the Proposing Release does not provide proper justification for the Proposal or evidence of its need. Rather than expand the scope of the current custody rule to include those assets which the SEC believes require further regulation, the Proposal fundamentally disrupts the current industry framework without any analysis presented to justify such a change. The assertion of a lack of proper oversight without sound evidence is not the basis upon which the SEC should regulate.

A. Written Agreements Between Investment Advisers and Custodians are Unworkable and Unnecessary

Under the current custody rule, the investment adviser and qualified custodian each have a clear role. The advisory client enters into an investment management agreement with one or more investment advisers for portfolio management services and separately enters into a custody agreement with one or more qualified custodians for custodial services. The investment adviser is appointed by the advisory client to act as their authorized agent with applicable authority within the client's account. Typically, advisory clients authorize their qualified custodians to accept trade instructions and fee deductions from the investment adviser. It is general industry practice for the contractual agreements between the investor and their appointed investment adviser and custodian to be separate and distinct from one another.

The Proposal seeks to alter that clarity and will create unnecessary confusion for investors. As the SEC acknowledges, "under existing market practices, advisers are rarely parties to the custodial agreement, which is generally between an advisory client and a qualified custodian."[4] Fashioning a contractual relationship between the investment adviser and the qualified custodian

[4] Proposing Release at 74.

in which the investment adviser plays an oversight role is unnecessary and unworkable. Investment advisers do not have the necessary negotiating power to ensure that all qualified custodians engaged by investors comply with the Proposal and will have no ability, or desire, to require investors to replace their qualified custodians when negotiations between the two break down. By intertwining the relationships, and by extension the contractual agreements, the Proposal is introducing a level of complexity with no added benefit to the advisory client.

The SEC's most recent amendments to the custody rule in 2009 were meant to "enhance the protections afforded to advisory clients' assets, harmonize the rule with current custodial practices, and clarify circumstances under which advisers have custody."[5] The regulatory framework created by these amendments provides greater transparency to clients about the trading activity within their accounts, as well as to when an investment adviser has custody of client assets. The amendments also codify the required use of a qualified custodian when an investment adviser has custody of client assets. The result of this requirement throughout the industry was the creation of a structure in which the client contracted directly with their chosen qualified custodian, without the direction, interference, or participation of the investment adviser.

The challenges presented by the Proposal are particularly impactful for institutional investment advisers. Although most retail investors only engage one custodian, institutional investors often engage multiple qualified custodians as well as multiple investment advisers to provide professional investment management. Due to the complexity of these relationships and the potential number of custodians and advisers involved with one institutional client, the negotiations required to ensure compliance with the Proposal as well as any terms required by the client will be extensive and complicated. The SEC's estimate of one hour per written agreement between the investment adviser and qualified custodian significantly underestimates the time that will be required to draft, negotiate, and implement each agreement. We are concerned that in the face of more overwhelming burdens from the SEC, some qualified custodians will cease offering custodial services altogether. As the qualified custodian industry shrinks as a result of the Proposal, investors will be forced to bring their business to fewer, larger qualified custodians thus limiting investor choice, increasing potential systemic risk, and creating a further imbalance of negotiating power in favor of these larger qualified custodians.

The Proposal unnecessarily forces broad industry changes to a current structure that effectively manages the risks of client assets and would represent a fundamental change in the relationship between the investment adviser and a qualified custodian. Even the Commission "acknowledge[s] that an agreement between the custodian and the investment adviser would be a substantial departure from current industry practice." [6] These changes will not only upend two decades of highly effective SEC rules and commercial market practices, but also would add new compliance hurdles and costs without any further benefit to investors.

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[5] *See* Custody of Funds or Securities of Clients by Investment Advisers *Supra n. 3*.
[6] Proposing Release at 77.

1. The Commission Should Not Prescribe Contractual Requirements Between Advisory Clients and Qualified Custodians

The Proposal imposes several requirements on the new investment adviser-qualified custodian agreement. We believe all the requirements, taken individually and as a whole, are, unnecessary, burdensome, and provide no further protections to investors. The proposed requirement that the investment adviser obtain reasonable assurance that the custodian will indemnify the client against loss, including having sufficient insurance coverage, will increase custodian cost and put the investment adviser in an oversight role.

The SEC is embarking upon new territory by attempting to prescribe specific indemnification and insurance requirements. It is overwhelmingly the case that existing U.S. financial services regulations allow for flexibility in allocating risk of loss, including addressing risks of misconduct through strict operating and reporting standards.

Nothing in the FINRA rules prescribes a minimum indemnification requirement for broker-dealers acting in a custodial capacity. Like the market for bank qualified custodians, we understand that the contractual protections offered by broker-dealers vary depending on the circumstances. But custodial assets are sufficiently protected nevertheless because there is a regulatory regime in place with which broker-dealers must comply.[7]

The same is true for futures commission merchants ("FCMs"), where neither the Commodity Exchange Act nor related regulations impose a specific liability or indemnification standard for FCMs.[8] Despite the lack of regulatory specificity, FCM customer funds are well protected because of a robust regulatory framework that emphasizes, among other things, the segregation of assets, restrictions on use of customer funds, and recordkeeping requirements.

Section 17 of the Investment Company Act, among other things, prohibits registered funds from including provisions in organizational documents and investment advisory and other agreements that protect directors and officers from liability to security holders arising out of the willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties of the directors or officers. But nothing in the Investment Company Act or its regulatory regime imposes an affirmative obligation on the part of registered funds to indemnify customers. Nor does the Investment Advisers Act of 1940 include an affirmative obligation to indemnify advisory clients.

In our view, the Commission should not attempt to prescribe a minimum standard for liability or contractual indemnification between parties. Rather, the Commission should promote

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[7] For example, broker-dealers that have custody of client funds and securities are subject to the customer protection rule, Exchange Act 15c3-3. Under that rule, broker-dealers are required promptly to obtain and maintain in their physical possession or control all of their customers' fully paid and excess margin securities. 17 CFR 240.15c3-3(b) and (c). Broker-dealers also are required by the rule to make regular calculations relating to the amount of funds obtained from customers or through the use of customer securities (credits) and compare it to the total amount it has extended to finance customer transactions (debits). If credits exceed debits, the broker-dealer is required to have on deposit in a Special Reserve Bank Account for the Exclusive Benefit of Customers at least an equal amount of cash or cash-equivalent securities. *See* Rule 15c3-3(e)(1).

[8] *See generally* 7 U.S.C. § 4d.

their ability to allocate risk freely as they see fit, relying on their experience and expertise. Flexibility in risk allocation is paramount to forming good custodial relationships and thus providing the adviser's clients with access to those new asset classes. On the other hand, imposing a minimum standard for liability and indemnification will increase the costs of custodial services, and cause further concentration risk by limiting the number of custodians that are willing to bear the associated costs, risks, and uncertainties of operating under that standard. Such substantial changes should only be undertaken after robust analysis to determine that a problem exists to justify such disruption.

2. Requiring Adequate Insurance is Vague and Unfeasible

While we agree that advisory clients should be shielded from, and reimbursed for, the misconduct, recklessness, and gross negligence of qualified custodians, we do not believe the Proposal's requirement that qualified custodians obtain proper insurance is appropriate. The obligation as written does not provide sufficient guidance on the type and amount of insurance that is acceptable, and the Proposal fails to provide any analysis on whether such insurance is even currently available to meet the proposed standards.

Fidelity does not believe the proposed requirement that the investment adviser ensure qualified custodians obtain insurance to protect advisory clients against the custodian's negligence is appropriate or necessary. Nevertheless, if the SEC were to move forward with this proposed requirement in a final rule adoption, we believe the qualified custodian community would benefit from certain clarifications. We are concerned that requiring insurance that "will adequately protect the client"[9] is vague and subject to various reasonable interpretations—and that the SEC may take exception to those interpretations in the future, without qualified custodians having the kind of advance notice that a more definitive final rule can and should provide. While flexibility in *complying* with rule requirements is typically useful, actual rule text that leaves too much to guesswork will not achieve its intended goal. Here, for instance, it would not necessarily be helpful for an investment adviser (or its client) to conclude that Custodian A is safer than Custodian B, solely on the basis that Custodian A has 100% insurance coverage for all claims while Custodian B has a different arrangement yet is in overall better financial condition or has more robust controls. And, given the complexity of insurance policies, advisers and their clients may not be able to discern the relative strength of insurance coverage maintained by different custodians. A qualified custodian determines what their own insurance requirements are based on a number of factors, including but not limited to regulatory requirements, contractual requirements, the nature and value of assets, the current control environment, loss probability analysis and insurance market availability. Custodians will not be in a position to change their insurance policy limits or coverage areas based on each investment adviser's independent assessment of what "will adequately protect the client".[10] Insurance policies are generally renewed on an annual basis with set terms and conditions and custodians will not be in position to make changes based on requests by each adviser if they deem coverage not adequate. Additionally, such requested changes may not be supported by the insurance market.

[9] Proposing Release at 86.
[10] *Id.*

We therefore urge the Commission to clarify that the qualified custodian should be the party that determines whether its insurance coverage is adequate for its business, or at least clarify that the adequacy of insurance coverage is but one of many factors to be considered by advisers as fiduciaries for their clients. More important among those factors is the overall financial condition of the qualified custodian as well as the custodian's specific custodial policies, practices, and internal control standards.

Broker-dealer qualified custodians are already subject to FINRA Rule 4360 which sets forth minimum requirements for Fidelity Bond coverage, and these additional insurance obligations are therefore duplicative and unnecessary.

3. Other Contractual Requirements are Duplicative and Unnecessary

The Proposal requires specific contractual terms that the qualified custodian must (i) provide records to the SEC upon request, (ii) send account statements to the advisory client at least quarterly, (iii) provide the investment adviser with an annual internal controls report that includes an opinion from an independent public accountant, and (iv) specify the investment adviser's agreed upon authority to effect transactions, including any limitations and how the adviser and client can reduce such authority. For broker-dealer custodians who are registered with the SEC and FINRA members, many of these requirements are already covered by existing rule requirements making the need for any new, additional written agreement unnecessary and unduly burdensome. Broker-dealers are already required to provide records to the SEC upon request and send account statements to customers on a quarterly basis.[11] Additionally, the current custody rule already requires investment advisers to ensure qualified custodians are sending statements to clients. It has not been sufficiently articulated as to why this existing rule requirement is no longer acceptable. These contractual requirements are duplicative for many qualified custodians, and therefore are unnecessary.[12] They introduce additional operational complexity without the corresponding benefit. At minimum, these duplicative requirements should be covered by an applicable exception to the extent they are already part of existing regulatory obligations.

(i) Internal Control Reports are Already Provided Upon Request

Many qualified custodians already prepare internal control reports which cover the custodian's safeguarding activities. These internal control reports, often SOC 1 Type 2 annual reports, which are generally made available to investment advisers for diligence purposes. As these reports can be made readily available upon request, any affirmative requirement the

[11] *See* FINRA Rule 2231 https://www.finra.org/rules-guidance/rulebooks/finra-rules/2231.

[12] We do request, however, that the Commission clarify in the Proposal the delivery obligation of account statements to pooled investment vehicles. The Proposing Release notes "the sender must look through that pool (and any pools in a control relationship with you or your related persons) in order to send to investors in those pools. If the qualifying custodian is considered the "sender", the qualified custodian would generally not have this information if the account is in the name of the pooled investment vehicle.

custodian must send such reports to an adviser is unnecessary, will result in additional costs passed to advisory clients and should only be made available upon request.

In the Proposing Release, the Commission explains that SOC 1 Type 2 Reports would be sufficient to meet the internal control report requirements,[13] but the time periods evaluated by such reports can vary. Most SOC 1 Type 2 Reports review the efficacy of controls over a six-month period, while some others review them over the course of twelve months.

The Proposal, however, is unclear about the necessary audit period required to meet the proposed obligation. The Proposal requires the report address whether the qualified custodian's controls are operating effectively to safeguard "the client assets held by that qualified custodian *during the year*,"[14] which could suggest a twelve-month audit period is necessary. But the Proposal also directs that the reports are to be obtained and provided to advisers "*[a]t least* annually," which suggests that reports with audit periods of less than twelve months may suffice. The Commission's commentary says only that the object of the report is to assure that custodian controls are effective "during the period specified."[15]

We pride ourselves on providing high-quality internal control reporting for our services. As the industry evolves, companies must ensure that new product offerings, when deployed, are properly covered by internal controls and reporting that can expand in response to such evolution. Fidelity does not oppose the expansion of required internal control reporting if appropriate time is provided to ensure that reporting procedures for newly covered services align with those it already applies elsewhere, and that they are of the same high quality.

(ii) Specifying the Adviser's Agreed-Upon Authority is Unnecessary and Not Practical to Implement

The Proposal would further require the written agreement to permit and outline how the investment adviser and advisory client can reduce any level of authority provided. As outlined above, investors appoint an investment adviser to act as an authorized agent with applicable authority as set forth in the custody agreement and/or applicable forms. Typically, investors authorize their qualified custodian to accept trade instructions, fee deductions, or other account instructions from their investment adviser. Broker-dealer qualified custodians already have a regulatory obligation to obtain any discretionary trading authorization from clients in writing.[16] Advisory clients and their investment advisers already have the ability to remove or reduce certain authorizations, thereby making any rule requirement unnecessary and duplicative. Fidelity, like many custodians, has standardized processes and requirements in order to administer custody relationships effectively. However, for many custodians, there is not an

[13] Proposing Release at 102.
[14] Proposing Release at 100.
[15] Proposing Release at 101. The guidance document cited by the Commission in a footnote uses similarly ambiguous language. *See id.* nn. 188, 193; *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)–2 Under the Investment Advisers Act of 1940*, Advisers Act Release No. 2969 (Dec. 30, 2009) (referring to evaluating the efficacy of controls "during the period specified").
[16] *See* FINRA Rule 408T available at https://www.finra.org/rules-guidance/rulebooks/temporary-dual-finra-nyse-member-rule-series/rule-408t.

operationally viable method to properly provide varying levels of adviser authority across a large number of clients without custodians limiting the scope of services or increasing the costs of the services it provides.

III. EXPANDING THE DEFINITION OF "CUSTODY" INTRODUCES CONFUSION

The Proposal's expansion of the definition of "custody" to explicitly include "discretionary authority" is unnecessary and introduces confusion into the investment adviser's role. The current custodial framework provides sufficient protections over advisory client assets and creating a differentiation between certain transaction settlement processes is unnecessary. Currently, a qualified custodian is able to reconcile any transaction, regardless of settlement type, and act as the books and records for the transaction. The further protections the Proposal is trying to afford to identify any client asset loss, misuse, or misappropriation within a matter of days after a transfer are not necessary, as the current SEC regulation already protects against such bad acts.

Additionally, in the Proposal's commentary, the Commission acknowledges that it is common for investment advisers offering retail managed account and separately managed account programs to engage third-party and/or affiliated sub-advisers to provide portfolio management services to program clients and that, as such, the expanded definition of custody would subject these relationships to the requirements of the rule. In particular, the Commission asks if it should "include an exception from the rule for assets for which the adviser provides advice in certain sub-adviser relationships, such as was described in our staff's statement." [17] We support the Commission codifying the existing exception to custody rule requirements[18] when (i) an affiliated sub-adviser provides discretionary portfolio management services pursuant to an investment advisory program in which an affiliate(s) is the qualified custodian and the primary adviser of the program, and (ii) the primary adviser is subject to and must comply with the custody rule. To remove such an exception from the rule would subject affiliated sub-advisers to the annual surprise examination requirement, the results of which would be duplicative of the primary adviser's examination, and therefore, would not provide additional protections to advisory clients.

[17] Proposing Release at 40, noting the Commission has previously provided relief from custody rule violations for certain affiliated sub-adviser relationships in a no-action letter, Investment Adviser Association (April 25, 2016).
[18] *See* Response of the Division of Investment Management IM Ref. No.: 20164261627 at Investment Adviser Association, April 25, 2016 (sec.gov).

IV. SEGREGATION REQUIREMENTS – RECOMMENDED EXCEPTION FOR BROKER-DEALER QUALIFIED CUSTODIANS

While the Proposal requires investment advisers to ensure qualified custodians are segregating client assets from proprietary assets, it does not provide an exception for registered broker-dealer qualified custodians, creating a duplicative and confusing regulatory framework. Broker-dealer custodians have long been subject to SEC Rule 15c3-3 under the Exchange Act ("Customer Protection Rule").[19] SEC Rule 15c3-3 requires broker-dealers that carry customer accounts to maintain possession and control of all fully paid and excess margin securities, and safeguard the net credit amounts owed to clients in a special reserve bank account for the exclusive benefit of clients and segregate these assets from the firm's proprietary assets. Any segregation requirement in the final rule should include an exception to note any such requirement would also be satisfied by the broker-dealer custodian's compliance with the Customer Protection Rule. Otherwise, it could be left open to reasonable interpretation as to whether a new or different standard has been created for broker-dealer custodians. The Customer Protection Rule has been highly effective in safeguarding customer assets since its implementation in 1972 and the SEC should recognize as such here.

V. EXPANDING THE SCOPE OF THE TERM "ASSETS" LIMITS INVESTOR CHOICE

The Proposal seeks to expand the definition of "assets" to include "other positions held in a client's account".[20] The Proposing Release acknowledges that this change to the definition will result in the inclusion of certain assets that cannot be maintained by a qualified custodian, including privately offered securities. Because of the way these securities operate, qualified custodians will be unable to maintain possession and control in compliance with the Proposal. Investment advisers that offer privately offered securities will therefore be required to utilize the proposed exception to the requirement that all assets be maintained at a qualified custodian. While Fidelity recognizes and appreciates the SEC's efforts to provide a reasonable exception for assets that cannot be maintained at a qualified custodian, we believe the specific requirements of the proposed exception are unfeasible.

The requirement that an investment adviser reasonably determine, based on facts and circumstances, that the client assets cannot be maintained at a qualified custodian is overly vague and will require an adviser to continually survey the qualified custodian industry to meet this obligation. Otherwise, the adviser opens itself up to scrutiny from the SEC or investors. This continual surveillance will increase adviser costs, which would likely be passed on to investors.

Further, the requirement to engage an independent auditor to review *all* changes in beneficial ownership coupled with the timing elements of the requirement, is unfeasible. The SEC has provided no analysis or data in the Proposing Release indicating that the audit industry

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[19] *See* 15c3-3 https://www.finra.org/sites/default/files/SEA.Rule_.15c3-3.pdf.
[20] Proposing Release at 27.

is large enough to support this requirement. If this requirement is adopted as proposed, certain advisers, unable to obtain the required number of independent auditors to comply with the exemption for all its client assets that cannot be maintained at qualified custodians, may refuse to take on those assets and shutter those services, limiting investor choice and driving industry consolidation.

Currently, independent auditors are engaged to perform surprise examinations or ensure annual financial statements are prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). The notion that an auditor has the ability to verify any purchase, sale or other transfer of beneficial ownership goes beyond the current scope of how advisers and auditors engage. It will require constant communication between the adviser and accountant and will increase both the complexity and cost of such an engagement, driving up investors' costs.

The Proposing Release is silent as to whether any analysis was completed to determine that enough PCAOB auditing firms exist and have the adequate staff to fulfill this proposed requirement for advisers. If the Proposal is adopted as written, every investment adviser that offers private fund investment will need to compete for a finite number of services, resulting in increased expenses which will be passed on to investors. Further, if enough PCAOB audit firms do not exist to facilitate this requirement, investment advisers may not have the ability to comply. This will likely lead to the liquidation of private funds and the limiting of investor choice.

VI. QUALIFIED CUSTODIANS INCLUDE STATE-CHARTERED TRUST COMPANIES

A. State-Chartered trust companies are "qualified custodians" under both the Custody Rule and the Proposed Rule because they are "banks" under the Advisers Act

State chartered limited purpose trust companies like Fidelity Digital Asset Services, LLC ("FDA") meet the definition of a bank under the Advisers Act because they are (i) trust companies that are (ii) doing business under the laws of a State and (iii) a substantial portion of their business "consists of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency."[21] Consistent with this interpretation, the SEC itself acknowledges that the current custody rule includes "state and federally-charted trusts."[22] The Commission argues that these same financial institutions should continue to be permitted to act as qualified custodians, and therefore the Proposal does not change the types of institutions that may serve as qualified custodians under the rule.[23] We agree with the Commission.

[21] 15 U.S.C. § 80b-2(a)(2)(C).
[22] Proposing Release at 256.
[23] Proposing Release at 43.

With respect to banks and savings associations, the Proposal includes largely the same definitions that exist under the current custody rule. It adds the new requirement that the bank or savings association hold client assets in an account that is designed to protect the assets from creditors in the event of insolvency or the failure of the bank or savings association. With respect to digital assets, we note that the law and regulatory framework is still developing regarding what measures will protect client assets from creditors. But we believe that trust companies in certain states, including New York, can comply with this additional requirement through provisions in their custodial agreements and therefore will continue to meet the definition of a qualified custodian. We appreciate the Commission's confirmation in the Proposal that state-chartered trust companies are eligible to be treated as qualified custodians.[24]

B. The qualified custodian definition should not be narrowed to exclude state-chartered trust companies

After acknowledging in the Proposal that banks, as defined in Section 202(a)(2) of the Advisers Act, the SEC requests input on whether that definition should be narrowed to include only certain kinds of banks and savings associations.[25] In particular, the Commission asks whether the definition should permit only banks or savings associations that are subject to Federal regulation and supervision, or, alternatively, only state banks and savings associations that are members of the Federal Reserve System. The question for both hypothetical scenarios, the Commission explains, is whether "narrowing of the types of banks and savings associations that meet the definition of qualified custodian provide additional protections to advisory clients in the event of the custodian's insolvency."[26]

Narrowing the definition of a qualified custodian in these ways would not promote the Commission's policy goals. State chartered trust companies are critical to the market for digital asset custody, but state-chartered trust companies provide an array of custody services for their customer's more traditional assets as well. In our view, continuing to allow state-chartered trust companies, particularly those subject to developed regulatory requirements, to act as qualified custodians would maintain a high standard of protection for all advisory clients.

The purpose of the qualified custodian requirement and definition is to identify financial institutions that "operate under regular government oversight, are subjected to periodic inspection and examination, have familiarity with providing custodial services, and are in a position to attest

[24] The Commission has previously requested input on whether state-chartered trust companies are qualified custodians under the Custody Rule. *See* Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets. In response, FDA provided the Commission with its analysis of how New York trust companies qualify. *See* FDA Letter to Commission Regarding Digital Asset Custodial Services, (Jan. 22, 2021), https://www.sec.gov/files/fidelity-digital-asset-services-012221.pdf ("FDA Digital Asset Custodial Services Letter").
[25] Proposing Release at 52, Question 19.
[26] *Id*.

to custodial customer holdings and transactions—all critical components of safeguarding client assets under the Proposed Rules."[27] State-chartered trust companies meet all of those conditions.

1. Oversight by the New York Department of Financial Services imposes on New York trust companies a high standard for custodying client assets

Perhaps most relevant to the Commission's concerns, for New York trust companies in particular, the New York Department of Financial Services ("NYDFS") has long and deep experience in supervising its regulated entities with respect to these—and many other—regulatory requirements designed to protect consumers of custodial services.

First, NYDFS is on the forefront of financial oversight, chartering new banks, trust companies, and BitLicensees of various types (and, in the latter case, creating a new regulatory regime for nonbank entities engaged in virtual currency activities), as well as taking wide-ranging and aggressive enforcement positions in cases of alleged compliance failures. According to its most recent annual report, NYDFS oversees nearly 3,000 banking and other financial institutions with assets totaling more than $8.8 trillion,[28] making it an appropriate and experienced primary regulator for a qualified custodian. In short, NYDFS sets a high standard for custody of client assets.

Second, regarding custody of digital assets in particular, New York state-chartered trust companies are providing the model that other providers of digital asset custody are likely to follow. For example, FDA manages omnibus wallets with client assets segregated at the books and records level, which means that clients do not have access to their own personal public/private keys.[29] FDA manages online ("hot") wallets as well as certain proprietary offline wallets (a/k/a "cold" or "deep cold"). The proprietary design of the offline wallets allows for risk segmentation with varying service level standards, geographic dispersion, and number of associates required to initiate transactions.[30] Most assets are held in the most secure "deep cold" storage, and FDA is solely responsible for managing the allocation between online/offline wallets.[31] These practices stack up favorably against the types of hot and cold storage that the Office of the Comptroller of the Currency ("OCC") suggested may be proper for national bank custodians.[32]

As the OCC explained in a 2020 interpretive letter acknowledging the authority of national banks to have custody of digital assets, these custody services, while based on the general power to hold real and personal property for customers, involve a specific kind of services linked to the

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[27] Proposing Release at 43.
[28] NYDFS, 2021 Annual Report, at 4 (June 15, 2022), https://www.dfs.ny.gov/reports_and_publications/annual_reports/2021_dfs_annual_report; *see also* NYDFS, About Us (last accessed April 1, 2023), https://www.dfs.ny.gov/About_Us.
[29] *See* FDA Digital Asset Custodial Services Letter, at 4 available at https://www.sec.gov/files/fidelity-digital-asset-services-012221.pdf.
[30] *Id.*
[31] *Id.*
[32] *See* OCC Interp. Ltr. #1170, at 5 (July 22, 2020), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.

technology underlying such assets: "[A] bank 'holding' digital currencies on behalf of a customer is actually taking possession of the cryptographic access keys to that unit of cryptocurrency… Holding the cryptographic access key to a unit of cryptocurrency is an electronic corollary of these traditional safekeeping activities."[33] Moreover, as the OCC went on to explain, those key custody services, including for digital asset securities,[34] is expected to be similar, if not identical, to the types of private key custody already provided by FDA under its New York trust company charter:

> Banks may offer different methods of providing cryptocurrency custody services, depending on their expertise, risk appetite, and business models. Some banks may offer to store copies of their customers' private keys while permitting the customer to retain their own copy. Such services may be more akin to traditional safekeeping and would permit the customer to retain direct control over their own cryptocurrencies. Other banks may permit customers to transfer their cryptocurrencies directly to control of the bank, thereby generating new private keys which would be held by the institution on behalf of the customer. Such services may be more akin to traditional custody services, but as with traditional custody, would not permit the customer to maintain direct control of the cryptocurrency. Banks may also offer other custody models that may be appropriate.[35]

The OCC further explained that "[t]he services national banks may provide in relation to the cryptocurrency they are custodying may include services such as facilitating the customer's cryptocurrency and fiat currency exchange transactions, transaction settlement, trade execution, recording keeping, valuation, tax services, reporting, or other appropriate services."[36] New York trust companies, for their part, may provide any or all of these same services. For example, FDA provides trade execution and reporting in connection with its custody of digital assets.

While the OCC has "pulled back" in its more recent guidance without rescinding its 2020 interpretive letter, NYDFS continues to supervise and regulate digital asset custodians effectively. New York trust companies offering custody of digital assets continue to be subject to even more demanding requirements than national banks, which, once trust powers are approved, generally can exercise those powers without further approval of the OCC. In contrast, NYDFS requires that New York trust companies that operate virtual currency businesses obtain separate approval for all material changes in their business. Even something as basic as taking custody of a new kind of digital asset may require separate NYDFS approval if the agency has not already "greenlisted" it.

Third, much like federal savings associations that the U.S. Supreme Court has characterized as being subject to "cradle to grave" regulation and oversight,[37] New York trust companies are subject to the extremely broad discretion and supervision of the NYDFS for the purpose of ensuring the safety and soundness of the organization and protecting the public interest.

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[33] *Id.* at 8.
[34] *Id*. at n.48 (noting that the subset digital asset custody related to digital asset securities would also be subject to Federal securities laws).
[35] *Id*. at n.37.
[36] *Id.* at n.39.
[37] *See Fidelity Fed. S. & L. v. De la Cuesta*, 458 U.S. 141, 145 (1982).

The New York Banking Law ("NYBL") authorizes the NYDFS Superintendent to "make such general rules and regulations as may be necessary and proper to effectuate the provisions of this chapter relating to the formation and operation of limited liability trust companies."[38] And the agency has expansive authority to issue rules, regulations and orders[39] to implement the general policy that "the business of all banking organizations shall be supervised and regulated through the department of financial services in such manner as to insure the safe and sound conduct of such business, to conserve their assets, to prevent hoarding of money, to eliminate unsound and destructive competition among such banking organizations and thus to maintain public confidence in such business and protect the public interest and the interests of depositors, creditors, shareholders and stockholders."[40]

Beyond enforcing specific regulatory reporting requirements,[41] NYDFS consistently exercises its authority to examine trust companies for compliance with law, for risk management, and for general safety and soundness.[42] Those actions include assessing standards for internal controls, client records, and segregation of assets—the same customer protections that the SEC has prioritized. Unlike the OCC, NYDFS recently set forth its expectations that custodians of digital assets segregate and protect client assets in analogous ways to those identified by the Proposal.[43] An investment adviser should therefore have at least the same level of comfort when relying on FDA for custody of digital assets as when relying on federally chartered banks or banks that are members of the Federal Reserve System.

(i) Excluding state-chartered trust companies from the qualified custodian definition would decrease custodial protections

Limiting qualified custodians to federally chartered institutions or state-chartered institutions who are members of the Federal Reserve System would artificially and unnecessarily shrink the market for, and quality of, custodial services without generating safety benefits for clients.

The Commission has estimated that as of March 9, 2023, there was only one national bank and four OCC-chartered trust companies offering custodial services for crypto assets, whereas approximately 20 state-chartered trust companies and other state-chartered, limited purpose banking entities offered such services.[44] State-chartered trust companies often work within a regulatory framework developed by their state legislatures and state regulators in order to protect and regulate custodial services specifically as they relate to digital assets. New York is a prime example. All New York trust companies are subject to a wide range of regulatory requirements

[38] NYBL § 102-a(4).
[39] *Id*. at § 14.
[40] *Id*. at § 10.
[41] *See* NYBL § 125.
[42] *See* NYBL § 36.
[43] NYDFS, Guidance on Custodial Structures for Customer Protection in the Event of Insolvency (Jan. 23, 2023), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures. ("NYDFS Custody Guidance").
[44] Proposing Release at 264.

pursuant to the New York Banking Law.[45] New York also applies additional requirements to trust companies that are engaged in "virtual currency business activities" that are specifically designed to mitigate risks associated with digital asset activities.[46]

The current custody rule already adequately mitigates risk to clients in a number of ways. The Advisers Act definition of "bank" incorporated by the rule requires state-chartered institutions to be "supervised and examined" by state authorities, and the definition excludes any institution operated for the purpose of evading the Act's requirements.[47] Those requirements have teeth, which is why the Commission has proposed adding similar requirements for Foreign Financial Institutions.[48] Moreover, the Proposal adds the requirement that an otherwise qualifying institution hold its client assets in an account designed to protect the assets from the institution's creditors in the event the institution becomes insolvent or fails.[49] That requirement itself will help mitigate any risks the Commission thinks could be posed by non-federally chartered or non-member institutions serving as qualified custodians.

In light of the foregoing, the specialization of state-chartered trust companies like those in New York will provide substantial enhancement to the overall protection of client interests, and the qualified custodian definition should continue to include them. The SEC should acknowledge the critical role that state-chartered trust companies fill in protecting client interests and ensuring that investment advisers and their clients continue to have access to the sophisticated custody services they provide.

VII. THE PROPOSAL CORRECTLY SUPPORTS THE USE OF OMNIBUS ACCOUNTS BY QUALIFIED CUSTODIANS

The Proposal requires written assurances that the qualified custodian will clearly identify advisory client assets as such, hold them in a custodial account, and segregate them from the custodian's own property.[50] The Commission clarified with regard to the segregation requirement that it did not intend to preclude "traditional operational practices in which client assets are held in omnibus accounts."[51] The Commission recognized that such practices are permitted because custodians "regularly maintain assets in a manner that allows such assets to be identified as held for a particular client, distinct from assets of other clients, and not subject to

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[45] *See, e.g.*, NYBL 4001 (initial capital required for a trust company; level to be set by Superintendent); NYDFS, Organization of a Trust Company for the Limited Purpose of Exercising Fiduciary Powers, https://www.dfs.ny.gov/apps_and_licensing/banks_and_trusts/procedure_certificate_merit_trust_comp (summarizing powers and limitations on limited purpose trust companies, providing, among other things, that the superintendent's minimum requirement for initial capital stock will not be less than $2,000,000).
[46] *See* NYDFS, Superintendent Adrienne A. Harris Releases Consumer Protection Guidance in the Event of Virtual Currency Insolvency (Jan. 23, 2023), https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202301231 ("The Department enters into supervisory agreements with virtual currency entities, including limited purpose trust companies, that specify required, restricted, and prohibited activities.").
[47] 15 U.S.C. § 80b-2(a)(2)(C).
[48] Proposing Release at 47.
[49] Proposing Release at 48.
[50] Proposing Release at 90.
[51] Proposing Release at 92.

increased risk of loss arising from a custodian's insolvency."[52] We agree with the Commission's clarification. And we confirm that holding custodial assets in an omnibus account with appropriate recordkeeping allows each customer asset to be identified as being held for that customer, and those assets are not subject to increased risk of loss arising from insolvency as a result of this accounting. We encourage the Commission to adopt this position as part of the final rule to help eliminate confusion that may exist in the marketplace regarding appropriate custodial practices for digital assets.

VIII. THE PROPOSED COMPLIANCE DEADLINE IS INSUFFICIENT

Implementing a new SEC rule of this magnitude requires time, attention, and resources, many of which are devoted to implementing other SEC rule changes. As noted above, the negotiation of written agreements between the investment adviser and the qualified custodian, as well as the implementation of a new compliance program to ensure the qualified custodian is meeting its written assurance obligations, are significant obligations for advisers and custodians. New operational processes, including the requirement for investment advisers and PCAOB auditors to exchange information pose a significant challenge to the financial industry. Further, given the pace and extent of the SEC's rulemaking, this is not the only proposal that will require implementation in the coming months. We believe the proposed compliance deadlines do not fully appreciate the complexities of the proposed changes or the time required to make such changes successfully.

The brief compliance period is particularly acute with respect to the internal control reporting requirements for custodians of digital assets. Fidelity already employs internal control reporting for many of our services as a best practice and as part of meeting the needs of our clients, but such reporting has taken time to develop, test, and deploy.

Additionally, as discussed above, we would ask the SEC to address our requests for guidance and clarity, specifically regarding the acceptable period of time for the internal control reports and the regulatory duplications presented by the Proposal. We also ask that the Commission take into consideration the impact the Proposal will have on current no action relief when adopting a final rule and compliance deadlines.[53]

To allow for the orderly, fulsome, and effective compliance of the Proposal, we urge the SEC to consider a compliance deadline of 36 months.

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[52] *Id.*; *see also* NYDFS Custody Guidance (setting forth NYDFS's expectations that custodians provide analogous protections).
[53] Such relief includes SEC Frequently Asked Questions which cover the handling of Standing Letters of Authorization, as well as no action letters related to the current custody rule.

Fidelity would be pleased to provide further information, participate in any direct outreach efforts the Commission undertakes, or respond to questions the Commission may have about our comments.

Sincerely,

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime Lizárraga, Commissioner

William Birdthistle, Director, Division of Investment Management