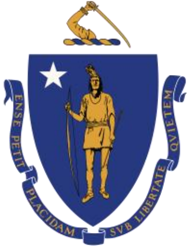

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April 27, 2023

Submitted via e-mail

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

RE: Release No. IA-6240; File No. S7-04-23: Safeguarding Advisory Client Assets

Dear Vanessa Countryman,

We submit this letter in response to the request for public input on the U.S. Securities and Exchange Commission's proposed amendments ("Proposed Rule") to Rule 206(4)-2 under the Advisers Act ("Custody Rule"). We appreciate the opportunity to provide the Commission with our perspective on the Proposed Rule and the need for enhanced investor protection in the cryptocurrency space as well as more disclosures on the risks associated with cryptocurrency investments.

The Commonwealth has a significant interest in protecting its citizens from fraud that permeates the cryptocurrency industry. As cryptocurrency has become more mainstream, the Massachusetts Attorney General's Office ("MA AGO") has observed a sharp increase in consumer complaints related to cryptocurrency investments. Many consumers fall prey to various cryptocurrency investment schemes, including bogus Initial Cryptocurrency Offerings ("ICOs"). In many instances, consumers, whose funds were stolen through cryptocurrency transactions, are left with no relief because the stolen funds were laundered by scammers through exchanges outside of U.S. regulatory reach. The volume of cryptocurrency-related complaints grew significantly as cryptocurrency exchanges began to crumble, prohibiting withdrawals and deeming their customers unsecured creditors. These complaints are often submitted by consumers with a rudimentary understanding of the cryptocurrency ecosystem. Swayed by polished user interfaces, ubiquitous advertising, and the endorsements of influential public figures, consumers misperceived centralized exchanges such as FTX as stable custodians. This misconception costs Massachusetts consumers millions of dollars. The MA AGO is in whole-hearted agreement with the Commission that tighter enforcement is needed in the cryptocurrency space. We concur with the Commission's position that advisors who engage in cryptocurrency transactions on behalf of their clients must ensure that the investors' funds are properly safeguarded and are not traded on exchanges that do not meet the Commission's threshold for qualified custodians.

The MA AGO is concerned, however, that while the Proposed Rule prohibits trades of cryptocurrency using centralized exchanges unless they satisfy the requirements of (d)(10) of the Proposed Rule, it leaves open the possibility for advisors to use decentralized exchanges to execute cryptocurrency trades without providing any protections or disclosures of risks for such vulnerable consumers. Decentralized exchanges are typically non-custodial, meaning users execute trades with other wallets directly through smart contracts. While decentralized exchanges may not require pre-funding of trades and thus could eliminate certain risks associated with trading on centralized exchanges, they pose substantial risks of their own.

For example, decentralized exchanges do not require users to submit Know-Your-Customer ("KYC") information. Instead, they allow users to trade anonymously on the platform, attracting a litany of bad actors. These include individuals and bots that attempt to manipulate cryptocurrency market prices or trade with stolen funds.

Additionally, decentralized exchanges, by their very nature, have no dedicated customer support structure—users experiencing technical difficulties on the exchange or who have fallen victim to an investment scam or hack through vulnerabilities in a smart contract have no available recourse. In combination with a lack of KYC protocols, the absence of customer support or designated representatives means that it would be practically impossible for a U.S. Regulator, such as the MA AGO, to trace or recoup, through seizure or forfeiture, any funds flowing through a decentralized exchange in association with unlawful investment activity.

Also, unlike centralized exchanges, decentralized exchanges often have no token listing requirements. Centralized exchanges typically inspect tokens prior to making them available for trading on the exchange to prevent exposing users to pump and dump projects and rug pull scams. However, users trading through a decentralized exchange receive no such protections.

The MA AGO, therefore, suggests that the Commission require advisors who trade clients' cryptocurrency assets through decentralized exchanges to provide clear and conspicuous disclosures of the risks and vulnerabilities associated with such exchanges. These disclosures should be provided to clients in writing prior to the advisor executing any trades on any decentralized exchange on the clients' behalf.

Consumers, especially those with a sophisticated understanding of cryptocurrency, may wish to continue to trade cryptocurrency despite the vulnerabilities associated with decentralized exchanges. Our suggestion does not prohibit advisors from executing trades on behalf of these clients through decentralized exchanges but provides greater security for consumers who may not be aware of the inherent risks decentralized exchanges pose.

The MA AGO is further concerned about whether the Proposed Rule sufficiently excludes privately offered cryptocurrency securities from the exception to the qualified custodian requirement.[1] The Proposed Rule amended the Custody Rule's definition of "privately offered securities" to require that a security's ownership be recorded on *non-public* books. In its commentary, the Commission explained that by adding the word "non-public" to the definition

[1] *See* Proposed Rule (b)(2) and (d)(9).

of “privately offered securities,” it intended to exclude privately offered cryptocurrency securities from the exception, as these securities are issued on public, permissionless blockchains rather than on non-public books. The MA AGO is concerned that this amendment may be insufficient in preventing various scenarios of ICO-related fraud.

The transfers of ICO investors’ funds are not always recorded on a blockchain, and even when they are, the records are not always public. To participate in an ICO, investors can use cryptocurrency or fiat. They can transfer their funds to the issuer by sending them to the issuer’s address, online wallet, payment processor, or other account. The investments could be immediately converted into ICO tokens or simply entitle an investor to a beneficial ownership in an ICO, either because the investment occurred pre-launch or through the sale of token warrants. This means that prior to the conversion event, these investments may be completely untraceable through a blockchain and would be recorded exclusively on the books of the issuer.

Furthermore, even when a conversion from a token warrant to a token occurs and a transaction is created on a blockchain, it could be done using privacy coins, which makes the transaction practically untraceable. When transactions are executed via privacy coins, the amounts sent, the identities of recipients, and the identities of the senders remain truly anonymous (unlike the pseudo-anonymity granted to senders and recipients of most other forms of cryptocurrency), which raises the question of whether a public record of ownership exists.

In the event the Proposed Rule retains the privately offered securities exception and defines the term “privately offered security” as drafted, the Commission should at least require advisors who invest their clients’ funds in an ICO to provide written, clear and conspicuous disclosures of the risks associated therein, including, but not limited to, the risk that the ICO issuer may abscond with the investors’ funds before the token launch or that there may not be a traceable record of the purchase of an ICO stake. Investors may wish to proceed with the ICO investment but will be in a better position to determine the level of risk to which they are prepared to be exposed.

Thank you for the opportunity to provide feedback on the Proposed Rule.

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