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By Electronic Mail

Division of Investment Management
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Custody Rule and Digital Assets

Polychain Capital LP ("Polychain") appreciates the opportunity to share its views regarding custodial practices and digital assets in response to the letter of March 12, 2019 (the "Request") from the Staff of the Division of Investment Management of the Securities and Exchange Commission (the "Commission") to the Investment Adviser Association.

I. Introduction

Polychain is an investment management firm that provides advisory services to privately offered pooled investment vehicles that invest in both a diversified portfolio of blockchain-based digital assets and early-stage companies that are active in blockchain technology and the digital assets market. Polychain is strongly committed to the purpose of the custody rule (defined below), including protecting client assets against being misappropriated and ensuring that investment advisers establish secure custodial arrangements for digital assets consistent with their fiduciary duties to their clients.

As recognized in the Request, the market for digital assets is evolving rapidly, with varied custodial opportunities for investment advisers developing at a significant pace, sometimes on a monthly basis. Moreover, the security and safekeeping considerations affecting the custody of digital assets differ significantly from those affecting securities, cash and other traditional financial instruments.

The distinct features of digital assets – access to and controls over public and private keys, the "bearer" like nature of digital assets, the anonymity and immutability of most blockchain transfers, acquisition of assets through unique usage opportunities (*e.g.*, staking) and distribution mechanisms (*e.g.*, forks and airdrops), and, of course, limited available custodians – require investment advisers to consider issues not fully addressed by existing Commission regulations and guidance. While in many instances it may be appropriate to maintain assets with custodians meeting traditional regulatory criteria, the use of those custodians often may neither be feasible nor best serve the interests of clients. Indeed, given the nature of digital assets and the fact that the digital asset custody field is itself still in development, the use of a third-party custodian may in some cases increase risk, particularly in the absence of effective due diligence by a knowledgeable investment adviser, and self-custody may be the mechanism best suited to ensuring the security of client assets.

Polychain and other market participants have made significant progress in tailoring custodial practices to reflect the distinct features of digital assets, with a view to protecting and accommodating clients investing in this asset class. Notably, spurred by both market forces and regulatory considerations, limited-purpose state-chartered trust companies and broker-dealers that meet the qualified custodian definition have been organized to offer custodial services for new assets in this rapidly evolving field. In addition, Polychain has developed policies and procedures designed not only to assess the quality of those custodians, but also to implement self-custody mechanisms where these mechanisms can provide for superior client protection.

Polychain thus encourages the Commission to update its regulatory requirements to reflect this evolving market environment and to help ensure a high level of protection for clients consistent with their interests and the objectives of Rule 206(4)-2 (the "custody rule") under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). The remainder of this letter, after first describing existing custodial practices in response to the questions raised by the Request, sets out clarifications and revisions to existing rules and guidance that would assist investment advisers in serving client interests in accordance with the Commission's mandate under the Advisers Act.

II. Current Custodial Practices and Framework

The Request seeks input on the challenges investment advisers face in meeting their custodial obligations in light of the characteristics of digital assets. To establish custodial arrangements for digital assets that appropriately protect the interests of their clients, investment advisers must assess a range of issues that affect the potential security of assets when held by a third party.

A. Access to Cryptographic Keys

Holding digital assets as a custodian ordinarily involves holding the cryptographic keys required to access those assets. Effectively controlling the private keys that direct asset movements between addresses on the blockchain generally entails consideration of: (i) how the private keys are generated (*e.g.*, could the keys have been compromised during generation?); (ii) how the keys are stored and accessed (*e.g.*, are the keys protected? are they encrypted?); and (iii) how the keys are used by the custodian (*e.g.*, does use expose them to compromise?).

A best practice for a custodian is to split access to the relevant private key, with each part held in multiple physical or digital locations (so as to mitigate the risk of loss) but no two parts held in the same location (so as to mitigate the risk of theft). Notably, in contrast to securities and more traditional assets, maintaining the key with a third-party custodian can introduce a degree of centralization that creates a single point of failure (and thereby increases risk), particularly if a custodian lacks security protocols that, in the judgment of the adviser, can securely keep each private key.

B. Monitoring for Risk of Unauthorized Transfers

Digital asset transactions frequently take place anonymously over publicly accessible blockchains. Such anonymity makes it more challenging to police theft, relative to unauthorized transfers of cash or securities to bank or brokerage accounts whose owners are much more easily identifiable. In addition, the immutability of transactions conducted over most blockchains makes it much more challenging (and frequently impossible) to reverse theft or loss, even if an owner of a digital wallet may be identified, and heightens the need to focus on the technological security considerations unique to the asset class.

C. Limited Availability of Qualified Custodians

Only a small number of institutions that currently offer custodial services for digital assets satisfy the Commission's regulatory requirements for "qualified custodians." The scarcity of qualified service providers can pose additional risk for advisers in establishing custodial arrangements and related operational practices. Most importantly, not all of the existing service providers engage in security practices designed, and have the technological capability, to: (i) segregate each adviser's or client's digital assets as required by the custody rule; (ii) ensure no single party has the ability to initiate or finalize the initiation of a transaction; (iii) identify and mitigate or stop new security threats, including software flaws and vulnerabilities, hacking and malware; and (iv) split access to private keys and geographically distribute them. Particularly since digital asset custodians are frequently institutions that are not as highly capitalized as traditional institutional securities custodians, deficiencies in these areas can pose significant risks to investors.

Moreover, third-party custodians support only a limited set of digital assets, posing both regulatory challenges for advisers and potential constraints on capital formation. Where no qualified custodian offers services for particular assets, compliance with the custody rule in its current form may prove effectively impossible for investment advisers. Compliance challenges are magnified for advisers who seek to invest in new blockchain projects because at inception and through the startup phase, the market is unlikely to provide a custodial option that meets the requirements of the custody rule.

D. Lack of Standardized Custodial Documentation and Practices

Consistent with the evolving nature of these markets, there also is lack of standardized custodial documentation and market practices. This market characteristic, coupled with the smaller number of available custodians, can lead to a greater ability for the custodian to dictate contractual terms, including pricing and apportionment of liability. These arrangements can place limits on how quickly an adviser can withdraw digital assets and, in some cases, might require conversion of those assets into fiat currency before withdrawal, either of which could limit an adviser's ability to obtain possession of digital assets quickly (*e.g.*, if it grew concerned about the risks of continuing to use a particular custodian). Further, standardized market conventions and policies have not yet developed for custodians' handling of forks and airdrops or of in-kind distributions and contributions, the lack of which can also contribute to uncertainty and risk.

E. Limited Benefits to Using Custodians

The benefits that a third-party custodian provides for cash and traditional securities are not necessarily apt for digital assets. These limited benefits and associated regulatory uncertainty have impeded the entrance of more numerous qualified custodians for digital assets. For example, insurance from the Federal Deposit Insurance Corporation is unavailable to cover the loss of digital assets in the bankruptcy or insolvency of a custodian and prudential standards under the regulatory regimes applicable to bank custodians are not as well-developed with respect to safekeeping of private keys as they are for traditional assets.

F. Limited Ability to Realize Opportunities from Evolving Use Cases

Third-party custodians also may constrain or impair the ability of advisory clients to realize the full benefits available from the use of their digital assets. A significant – and rapidly evolving – element of digital asset networks is the ability to exercise ownership rights to generate additional returns or otherwise advance holders' interests. Qualified third-party custodians face challenges that limit their ability to pass these benefits to holders, particularly in light of the pace at which new usage opportunities are being conceived and implemented. For example, advisers whose assets are held at third-party custodians would generally face significant restrictions (or would be unable) to engage in the following activities:

- *Staking*. Digital asset holders, whether acting through investment advisers or otherwise, frequently can enhance returns by engaging in "staking" activities.[1] These activities entail the use of digital assets to support the validation and authentication of transactions

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[1] "Staking" is only possible for digital assets that use a "proof of stake" algorithm to achieve consensus. For these digital assets, the amount of digital assets controlled by a user can improve its ability to validate transactions on a blockchain and therefore obtain profits (*e.g.*, Tezos).

on the blockchain for that digital asset, which generates rewards in the form of cash or additional digital assets.

- *Non-Staking Network Operations*. On some networks, rewards are not generated merely by staking. For example, to generate rewards on the Terra network, a digital asset holder must operate an "oracle," which entitles the holder to vote on the price of network assets. Other networks are expected to develop similar features.

- *Network Governance.* In many instances, asset holders may seek to participate in non-delegated voting for the purpose of making decisions on networks. These could include votes on matters important to maintaining network stability. Notably, given that minimum voting thresholds generally must be satisfied, low participation rates can prevent networks from making important security and governance improvements (and thereby increase risk, decrease a network's value and adversely affect investment returns).

- *Signaling/Lockdrops.* An emerging method for developers of new networks to initially attract users is to use a so-called "lockdrop." Under this arrangement, digital asset holders on one network (*e.g.*, Ethereum) agree to "lock" their tokens for a specified period of time in exchange for digital assets in another (*e.g.*, Edgeware), with a longer lock duration entitling a holder to proportionally more tokens. This distribution method "signals" the intent of influential market participants to participate in a new network, which can in turn facilitate the growth and security of new digital asset projects.

While a few third-party custodians have gradually begun to support staking for a limited subset of digital assets, their ability to support the full set of use cases outlined above is still very limited. More importantly, given the pace at which the market is evolving, their support will inevitably continue to lag behind in areas of potential significance to investors.

From an investor perspective, moreover, many of the use cases require a careful and tailored analysis of risk and reward for which investment advisers are better suited than third-party custodians. These decisions, like those relating to forks and airdrops noted above, will not necessarily have a one-size-fits-all solution. As in the case of more traditional investment decisions, they may require a balance of risk (*e.g.*, potential exposure to bugs or hacks associated with participation in activities) against reward (including not only directly measurable economic returns, but also enhancement or preservation of the value of the network). Custodians, even though they may frequently assist in seeking to limit risk, do not have the information regarding investor objectives, or the expertise and tools, to evaluate and make these trade-offs all investment advisory clients participating in the market for digital assets.

In light of these issues, maintaining digital assets with a third-party custodian may not, at least in the current state of the market, be the most effective means for an adviser to discharge its fiduciary duty to safeguard client assets and put clients' interests first – and may even give rise to adverse collateral consequences for network developments critical to preserving the value of a client's holdings of digital assets. Therefore, the existing market practice is generally a composite approach of using qualified custodians and self-custody.

III. Clarifications and Revisions to Existing Rules and Guidance

The Request asks for specific factors the Staff should evaluate when considering amendments to the custody rule to address digital assets. Below we set out recommendations for clarifications and revisions to existing requirements and expectations that in our view would, in light of the issues summarized above, advance the custody rule's objective to protect advisory client assets from "being lost, misused, misappropriated or subject to adviser's financial reverses."[2]

A. Qualified Relief Permitting Self-Custody

We recommend that the staff permit investment advisers to self-custody digital assets in circumstances where, upon review, the adviser appropriately determines that a third-party custodian would not better serve the interests of its advisory clients. More specifically, we request that the Commission consider no-action relief or adopt an exception from the custody rule permitting an investment adviser, in connection with clients that are private funds and separately managed account clients who are qualified clients, to self-custody digital assets[3] under the following conditions, where the adviser concludes that those assets cannot safely be held at a qualified custodian:

- The adviser determines that using a qualified custodian would not be consistent with its fiduciary duty based on considering the following three factors: (i) the availability of a qualified custodian that supports a particular asset; (ii) the security protocols of such qualified custodian; and (iii) the benefits to clients of pursuing a particular digital asset

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2 "Custody of Funds or Securities of Clients by Investment Advisers," 75 Fed. Reg. 1456, 1457 (Jan. 11, 2010); *see* SEC National Exam Program Risk Alert: Significant Deficiencies Involving Adviser Custody and Safety of Client Assets (Mar. 4, 2013) (noting that the custody rule is "designed to protect advisory clients from the misuse or misappropriation of their funds and securities"); *see also* "Custody or Possession of Funds or Securities of Clients," 27 Fed. Reg. 2149, 2149 (Mar. 6, 1962) ("The new rule is designed to require advisers to maintain client funds or securities in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser.").

3 For purposes of this request, by referencing "digital assets" we are including only those digital assets subject to blockchain transfer that constitute securities or funds subject to the custody rule. We note that, to the extent the Commission adopts appropriate self-custody relief, it could reduce the need to make difficult distinctions regarding whether a particular asset constitutes "securities or funds" for these purposes by affording an advisers a practical and non-formalistic approach to satisfying their custodial obligations, regardless of the formalistic characterization of the assets.

(or application of an asset) and the costs of foregoing that opportunity in light of the risks presented by third-party or self-custody arrangements;[4]

- The adviser provides enhanced disclosure of self-custody arrangements for digital assets in Part II of Form ADV;

- For clients that are pooled investment vehicles, the adviser has the vehicle's transactions and assets audited at least annually, distributes its audited financial statements to all limited partners (or members or other beneficial owners) and distributes account statements at least quarterly to these investors; and

- The adviser establishes written policies addressing self-custody that would assist in effective Commission oversight and review and designates an individual (who is a supervised person) responsible for administering them (i.e., a chief security officer).[5] This individual should be competent and knowledgeable regarding security practices for digital assets and have sufficient seniority and authority within the organization to compel others to adhere to the self-custody policies.[6]

We note that there is ample precedent for the Staff to provide this relief for digital assets. The custody rule is not intended to operate as a restriction on an adviser's ability to make investments. Digital assets are an important emerging asset class. Indeed, the Commission has in the past expanded the custody rule to accommodate the growth of certain markets, for example, by expanding the set of entities that may serve as qualified custodians to include futures commission merchants and foreign banks to facilitate investments in futures and non-U.S. securities, respectively.[7]

Moreover, digital assets also bear similarity to mutual fund shares and private securities, which advisers are currently permitted to self-custody and do not require the use of an intermediary. An investor's ownership of digital assets frequently is recorded directly on the blockchain, rather than through an intermediary, like recording an investor's ownership of mutual fund shares or private securities directly on the books of the issuer or its transfer agent.

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4 The Commission may want to consider what documentation of these determinations would be appropriate (*e.g.*, recording the determinations in a file memorandum as part of the adviser's records).

5 *See* Rule 206(4)-7 (imposing similar requirements for advisers' compliance programs and personnel). Polychain would welcome a dialogue with the Staff to explore any other parameters to the exception that it may wish to consider.

6 *See* "Compliance Programs of Investment Companies and Investment Advisers," 68 Fed. Reg. 74714, 74720 (Dec. 24, 2003) (describing similar expectations for advisers' chief compliance officers).

7 *See, e.g.*, 68 Fed. Reg. at 56693-94 ("In order to allow advisers that also offer futures advice to comply with the Commodity Futures Trading Commission rules, 'qualified custodians' also include registered futures commission merchants").

Although there typically is no transfer agent involved for digital assets, ownership of digital assets is validated on blockchains that are secured through cryptography.

B. Application of Authorized Trading Exception to Digital Assets

The Request asks whether the settlement process for digital assets that are executed on trading platforms or over-the-counter ("OTC") may present risks. In this regard, we note that transactions in digital assets that are executed on exchanges and are settled on the books of the exchange often are settled instantly upon simultaneous receipt of cash or other assets,[8] whereas this scenario is less likely to arise in OTC transactions.

Accordingly, we respectfully request that the Staff confirm that they will treat these digital asset exchange transactions as falling within existing guidance that advisers should not be viewed as having custody over assets that are settled under delivery-versus-payment arrangements.[9] Where a digital asset is traded on an exchange and settled on the books of the exchange, the risk of theft or misappropriation is low because a custodian could transfer funds (or securities) out of a client's account only upon corresponding transfer of securities (or funds) into the account. As the Staff described in the Request, this rationale has led the Commission to provide guidance that authority to withdraw funds or securities maintained by a custodian to effect or settle trades does not constitute custody.

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We appreciate your consideration of our comments on the Request. If we can answer any questions or provide any further information, please do not hesitate to contact the undersigned (917-301-6002; ruby@polychain.capital) or our counsel, Giovanni Prezioso of Cleary Gottlieb Steen & Hamilton LLP (202-974-1650; gprezioso@cgsh.com).

Very truly yours,

Ruby G. Sekhon
General Counsel &
Chief Compliance Officer

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[8] *See, e.g.*, Coinbase User Agreement § 3.2 (last accessed Apr. 11, 2019) ("Purchased Digital Currency will be deposited in your Digital Currency Wallet as soon as funds have settled to Coinbase, which in the case of a bank account or credit or debit card may take up to five business days."); Gemini User Agreement, "Order Settlement" (last accessed Apr. 11, 2019) ("All Orders that are filled, executed, or matched . . . settle immediately and are recorded on our Exchange Ledger.").

[9] 68 Fed. Reg. at 56693 n. 18; SEC IM Guidance Update No. 2017-01, Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority (Feb. 2017).