CHAPMAN
Focused on Finance

Chapman and Cutler LLP
320 South Canal Street, 27th Floor
Chicago, Illinois 60606-5707

T 312.845.3000

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By Email

Commissioner Hester M. Peirce
Chair of SEC Crypto Task Force
crypto@SEC.GOV
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: Crypto Custody under the Investment Company Act of 1940

Dear Commissioner Peirce and Members of the SEC Crypto Task Force:

On behalf of The Digital Chamber (*"TDC"*), we respectfully provide this submission in response to Commissioner Hester M. Peirce's February 21, 2025 statement soliciting public input on regulatory issues related to blockchain technology and crypto assets (the *"Statement"*).[1] In particular, this letter addresses Questions 30 through 32 of the Statement related to the Commission's review of listing applications for crypto asset-based exchange-traded products (*"ETPs"*). TDC is providing responses to many of the other questions posed by the Statement in separate submissions.

Formed in 2014, TDC is the world's largest digital asset and blockchain trade association. TDC represents more than 200 companies innovating in the digital asset and blockchain industry. Guided by the principle of industry compliance with applicable law, TDC seeks to foster a legal and regulatory environment in which digital asset users can enjoy regulatory clarity as they apply blockchain technologies to an array of commercial, technological, and social purposes. TDC encourages industry compliance with the federal securities laws through initiatives like the Token Alliance, a network of 400+ TDC-member thought leaders and technologists that have developed numerous tools and resources for industry participants and policymakers as they engage with the digital asset economy.

As explained herein, we believe that the Commission should (1) provide guidance that state-chartered trust companies and similar institutions qualify as "banks" for purposes of Section 17(f) of the Investment Company Act of 1940 (the *"1940 Act"*); and (2) provide guidance that "custody" under the 1940 Act with respect to crypto assets means possession of the private keys associated with such assets.

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1 Comm'r Hester M. Peirce, *There Must Be Some Way Out of Here*, U.S. Sec. & Exch. Comm'n (Feb. 21, 2025), https://www.sec.gov/newsroom/speeches-statements/peirce-statement-rfi-022125.

<u>Question 30</u>

What challenges do registered investment companies ("funds") face in complying with section 17(f) of the 1940 Act and the rules thereunder (governing custody) with respect to investments in crypto assets? Are any specific requirements of section 17(f) or the rules thereunder categorically inconsistent with custody of crypto assets? Do funds anticipate that custodians currently eligible to act as fund custodians under the 1940 Act and the custody rules (*e.g.*, banks, foreign banks, broker-dealers) will offer fund custodial services for crypto assets?

Registered investment companies (*"funds"*) are increasingly interested in participating in the rapidly evolving crypto asset markets. However, the unique characteristics of crypto assets, the structure of the current custodial ecosystem, and the emergence of new activities such as staking and decentralized finance (DeFi) protocols present significant challenges for funds seeking to comply with the custody requirements of Section 17(f) of the 1940 Act and the rules thereunder. Our response provides an analysis of the principal challenges, the limitations of the current regulatory framework, and detailed recommendations for regulatory adjustments to facilitate responsible and secure fund participation in crypto asset markets.

Challenges in Complying with Section 17(f) Custody Requirements

Section 17(f) of the 1940 Act establishes strict requirements for the custody of securities and similar investments held by registered management investment companies. Specifically, it mandates that such assets must be placed in the custody of: (1) a bank meeting certain requirements; (2) a member of a national securities exchange (*i.e.,* a broker-dealer), subject to any Commission rules; or (3) the company itself, in accordance with Commission rules. The intent behind these requirements is to ensure the safekeeping of fund assets and to protect investors from risks such as theft, loss, or misappropriation.

The application of Section 17(f) to crypto assets is complicated by the fact that the vast majority of established crypto asset custodians are not banks or broker-dealers. While some banks have begun to offer limited custody solutions for crypto assets, these services are not yet widely available or comprehensive. Most crypto custodians are structured as state-chartered trust companies or other entities that do not fit neatly within the existing definition of "bank"[2] or

2 Under Section 2(a)(5) of the 1940 Act, "bank" means (A) a depository institution (as defined in Section 3 of the Federal Deposit Insurance Act) or a branch or agency of a foreign bank (as such terms are defined in Section 1(b) of the International Banking Act of 1978), (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the

"broker-dealer" under Section 17(f). This creates a significant compliance challenge for funds seeking to invest in crypto assets, as they may be unable to find eligible custodians that meet the statutory requirements.

The lack of clarity regarding the eligibility of state-chartered trust companies and other prudentially regulated entities further complicates the landscape. Funds are left uncertain as to whether custody arrangements with these entities would satisfy the requirements of Section 17(f), potentially exposing them to regulatory risk. This uncertainty may deter funds from participating in the crypto asset markets altogether, limiting investor access to this emerging asset class.

The Commission should issue interpretive guidance confirming that state-chartered trust companies and similar federal or state-chartered entities subject to prudential regulation qualify as "banks" under Section 17(f). This would provide much-needed clarity and enable funds to utilize the services of reputable crypto custodians that are subject to robust regulatory oversight. While such entities are not "banks" within the ordinary understanding of the term, the 1940 Act provides the Commission with a flexible enough definition to reach the conclusion that such entities lie within the 1940 Act's definition of the term. Specifically, Section 2(a)(5)(C) includes within the definition of "bank" "any other banking institution or **trust company**, whether incorporated or not, doing business under the laws of any State or of the United States, **a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency**, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title." State-chartered trust companies fit within this definition for two reasons. First, because the term "deposits" is not defined under the 1940 Act, a reasonable interpretation of such term could be the deposit of assets with such entity in a custodial capacity. The 1940 Act does not distinguish between types of deposits, nor is the Commission bound by the meaning assigned by other regulators. Accordingly, the Commission could easily interpret "receiving deposits" to include the types of activities in which crypto asset custodians are already engaged. Second, the Commission could also find that state-chartered trust companies exercise fiduciary powers similar to those permitted to national banks because, in their capacity as custodian, such entities have fiduciary responsibility to safekeep their customers' assets.[3] Because Section 2(a)(5)(C) does not provide specificity as to the types of

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Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this title, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clause (A), (B), or (C) of this paragraph.

3 This position was largely supported by Commissioner Uyeda, who in recent remarks stated: "Limited purpose trust companies with the authorization of a state banking regulator, such as the New York State Department of Financial Services or the California Department of Financial Protection and Innovation, might be able to

fiduciary powers exercised by banks, the Commission has the ability to interpret such term broadly to be inclusive of crypto asset custodians.[4]

In a separate letter previously submitted to you, we recommended that the Commission should expand the definition of "qualified custodian" under the Investment Advisers Act of 1940 (the *"Advisers Act"*) to expressly include state-chartered trust companies.[5] While the "qualified custodian" definition under the Advisers Act has historically contemplated a broader category of custodians than Section 17(f) of the 1940 Act does, there is no good policy rationale for separate standards of crypto custody under the Advisers Act and the 1940 Act. Accordingly, we strongly urge the Commission to harmonize the standards for eligible custodians for crypto assets under both the Advisers Act and the 1940 Act to provide a consistent framework for investment managers that is indifferent to whether such assets are held in registered investment companies, private funds, separate accounts, or other investment wrappers.

Inadequacy of the Current Definition of "Custody" under Section 17(f) for Crypto Assets

The concept of "custody" under Section 17(f) of the 1940 Act is rooted in the context of traditional securities and physical assets. It requires that a registered investment company's securities and similar investments be placed in the custody of a bank, a member of a national securities exchange (*i.e.,* a broker-dealer), or the company itself, subject to Commission rules. The regulatory framework presumes that assets are tangible or represented by physical certificates, and that custody involves physical possession, segregation, and safekeeping in a vault or depository supervised by federal or state authorities.

This approach is fundamentally inadequate for crypto assets for several reasons. Crypto assets exist solely as digital entries on a blockchain and are controlled through cryptographic private keys, not physical certificates or instruments. The concept of "physical possession" is inapplicable, as there is no tangible asset to be held in a vault or depository. The operational

custody crypto assets as fiduciaries arguably 'exercise fiduciary powers similar to those permitted to national banks' under the authority of the Office of the Comptroller of the Currency." Mark T. Uyeda, Remarks to Crypto Task Force Roundtable on Custody (Apr. 25, 2025).

4 Such an interpretive position would be consistent with previously issued staff guidance accommodating non-security assets in registered investment companies. For example, in 2014 the staff issued a no-action letter providing that certain metals held by a registered investment company may be held by a precious metals depository and security service. *See* The Brink's Co., SEC No-Act. (pub. avail. Feb. 11, 2014).

5 *See* Investment Adviser Custody and Other Requirements, THE DIGITAL CHAMBER (May 12, 2025), available at https://www.sec.gov/files/tdc-response-051225.pdf (the *"Advisers Act Custody Letter"*).

requirements of Section 17(f) and its rules, such as physical segregation and withdrawal procedures, are incompatible with the instantaneous, digital, and decentralized nature of crypto asset transactions. The current framework also does not clearly define what constitutes "custody" in the context of crypto assets. This ambiguity is particularly problematic for activities unique to crypto, such as staking or participation in decentralized finance (DeFi) protocols, where assets may be temporarily delegated or locked in smart contracts without transferring control to a third party in the traditional sense. Without clear guidance, funds face uncertainty and potential regulatory risk when engaging in these activities. While some commentators have pointed to Rule 17f-2 as a possible solution, that rule requires that securities be deposited in the safekeeping of a bank or other supervised depository, with physical segregation and withdrawal only in the ordinary course of business. This "physical" requirement is fundamentally incompatible with the digital nature of crypto assets and would burden fund managers as they seek to trade or otherwise make use of the crypto assets for the benefit of the fund's shareholders.

A narrow definition of "custody" with respect to crypto assets—focused specifically on the possession or control of the private keys associated with a particular crypto asset—would directly address the shortcomings of the current framework. Private keys are the cryptographic credentials that confer control over digital assets on a blockchain. Whoever possesses the private key has the ability to transfer or otherwise exercise dominion over the asset. If custody is defined to mean possession or control of the private key, the regulatory framework would be directly aligned with the technological reality of how crypto assets are held and transferred, rather than relying on outdated concepts of physical possession. A private key-based definition provides clear, objective criteria for determining who is acting as a custodian of crypto assets. This clarity would enable funds to structure their custody arrangements in compliance with regulatory requirements, and would allow the Commission to more effectively oversee and regulate custodial practices in the crypto space.

Further, by focusing on private key control, the definition of custody would avoid inappropriately sweeping in non-custodial activities—such as participation in staking or DeFi protocols—where the fund may delegate certain rights or functions without relinquishing control of the private key. This ensures that only those entities or arrangements that actually have the ability to access or transfer the assets are subject to custody regulations, while ancillary activities are regulated through disclosure, board oversight, and liquidity safeguards. A private key-based definition would enable funds to participate in innovative crypto activities without running afoul of custody rules designed for a different era. At the same time, it would maintain robust investor protections by ensuring that only those with actual control over fund assets are subject to the highest standards of oversight and security.

While the proposed narrow definition of custody would largely prevent Section 17(f) from being fatal to many innovations in crypto-based funds, the other provisions 1940 Act would still provide significant protections to investors in such products, including:

- **Full and Fair Disclosure:** Funds would still be required to provide comprehensive disclosures to investors regarding their participation in staking, DeFi, and other crypto-related activities, including the associated risks and potential rewards.

- **Board Oversight:** All such ancillary crypto activities should be presented to and approved by the fund's board of directors, ensuring appropriate governance and oversight.

- **Liquidity Safeguards:** For open-end management companies, appropriate safeguards would be required under Rule 22e-4 to ensure that participation in crypto activities does not compromise the fund's liquidity or its ability to meet redemption requests.

- **Audit Requirements:** Funds would be required to obtain an annual audit in accordance with the 1940 Act, which includes confirmation of all investments by independent public accountants.

These existing safeguards should provide the Commission with confidence that a narrow definition of custody would subject fund investors to meaningful additional risk.

Question 31

Can a fund comply with the requirements of section 17(f) and the rules thereunder when trading, staking, voting, or otherwise engaging with crypto assets in which it invests? Should the Commission consider any changes to rule 17f-2 (the self-custody rule) or any other rules to facilitate transactions in crypto assets, and if so, what tailored conditions should the Commission propose to mitigate any related risks?

While Rule 17f-2 nominally allows for self-custody of crypto assets, Rule 17f-2 is insufficient for most funds dealing with crypto assets due to its outdated framework that does not adequately address the unique characteristics and risks associated with crypto assets. Rule 17f-2 primarily focuses on traditional securities and physical custody, lacking provisions for the technological and security measures necessary for safeguarding crypto assets. This gap leaves investment companies reliant on third-party custodians who may not have the specialized expertise or infrastructure to effectively manage and secure crypto assets.

Due to these limitations, we recommend that the Commission propose a custody rule specifically tailored to the unique characteristics of crypto assets (rather than requiring compliance with Rule 17f-2). As stated above, this rule should align with the custody requirements under Rule 206(4)-2 of the Investment Advisers Act of 1940 (or any successor rule), which already contemplates the unique risks and operational realities of crypto assets.[6] A crypto asset-specific custody rule would provide a clear and consistent framework for funds, custodians, and regulators alike. Such a rule should address the operational realities of crypto asset custody, including the use of multi-signature wallets, cold storage solutions, and other technological safeguards in a flexible manner that allows for adoption of new solutions as they are developed.

Critically, any proposed crypto asset custody rule should permit registered investment companies to self-custody crypto assets to align with the evolving landscape of digital finance and to enhance investor protection.

Self-custody of crypto assets by investment companies offers several significant advantages, including increased security and control over assets, reduced reliance on third-party custodians, and potentially lower costs. Self-custody would allow investment companies to implement robust security measures tailored to their specific needs, such as multi-signature wallets and cold storage solutions, which can mitigate the risks associated with hacking and fraud. Furthermore, self-custody can streamline operations and reduce fees associated with external custodians, ultimately benefiting investors through lower costs and improved efficiency.

A rule allowing investment companies to self-custody crypto assets could also include some or all of the following investor protection safeguards:

1. **Robust Security Standards:** Require investment companies to implement advanced cybersecurity measures to protect crypto assets from theft, hacking, and other cyber threats. Mandate regular security audits and penetration testing by independent third parties.

2. **Insurance Requirements:** Require investment companies to maintain insurance coverage to protect against losses due to theft or cyberattacks.

3. **Operational Risk Management:** Establish comprehensive risk management frameworks to address operational risks associated with self-custody. Require detailed policies and procedures for handling crypto assets.

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6 *See* Advisers Act Custody Letter.

4. **Transparency and Reporting:** Mandate regular reporting to the SEC and investors on the status and security of crypto assets. Require disclosure of any security breaches or incidents affecting the crypto assets.

5. **Independent Oversight:** Establish requirements for independent oversight or third-party verification of the self-custody practices.

6. **Risk Disclosure:** Ensure investors are informed about the specific risks associated with self-custody.

7. **Contingency Planning:** Require investment companies to have contingency plans in place for recovering assets in the event of a security breach or system failure.

8. **Periodic Review and Updates:** Implement a mechanism for periodic review and updates to the rule to adapt to evolving technology and threats.

The adoption of such a rule would demonstrate the Commission's commitment to fostering innovation within the financial sector while maintaining rigorous standards for investor protection. As recently stated by Commissioner Atkins, "The right to have self-custody of one's private property is a foundational American value that should not disappear when one logs onto the internet. I am in favor of affording greater flexibility to market participants to self-custody crypto assets, especially where intermediation imposes unnecessary transaction costs or restricts the ability to engage in staking and other on-chain activities."[7]

As the crypto market continues to mature, regulatory frameworks must adapt to accommodate new asset classes and technologies. By permitting self-custody, the SEC can encourage responsible management of crypto assets by investment companies, ensuring that they adhere to best practices in security and risk management. This approach would not only support the growth of the digital asset industry but also provide investors with greater confidence in the safety and integrity of their investments. However, it is crucial that any rule adopted include stringent requirements for risk assessment, security protocols, and regular audits to ensure that self-custody practices meet the highest standards of safety and compliance.

<u>**Question 32**</u>

Should any provisions relating to investment company custody be revised to account for investment activities or other transactions that are unique to crypto assets (*e.g.*, staking,

7 Paul S. Atkins, Remarks at the Crypto Task Force Roundtable on Decentralized Finance (June 9, 2025).

mining, airdrops)? Do the existing custody rules present obstacles to such activities or transactions? How might these activities or transactions place a fund's assets at risk of theft or loss?

In addition to proposing a new rule permitting investment companies to self-custody of crypto assets, the SEC should also include in such rulemaking proposal considerations for investment activities unique to crypto assets—such as staking, mining, and airdrops—that do not fit cleanly into the existing custody rules. These activities often involve the temporary transfer or delegation of control over assets, the receipt of new or derivative assets, or the participation in decentralized protocols.

1. **Staking.** Staking typically involves committing crypto assets to a protocol in order to support network operations and earn rewards. While the assets may be locked or delegated, they are not necessarily under the control of a third-party custodian. The current custody rules do not clearly address how staked assets should be treated, creating uncertainty for funds. A crypto asset-focused rule should provide clarity on the types of staking that are permissible (*e.g.,* self-staking, custodial staking, staking pools, liquid staking tokens, etc.), how to determine the liquidity of staked assets, and the procedures fund boards should implement to approve of such staking programs.

2. **Mining.** Mining involves the use of computational resources to validate transactions and secure blockchain networks, often resulting in the receipt of newly created crypto assets. The custody of mined assets may not fit neatly within the existing regulatory framework, particularly if the assets are received directly from the protocol rather than through a traditional custodian. As with staking, the Commission should develop a custody rule that implements appropriate safeguards for mining activities without stifling innovation.

3. **Airdrops.** Airdrops involve the distribution of new crypto assets to holders of existing assets, often as a reward or incentive. The receipt and custody of airdropped assets may present unique challenges, particularly if the assets are not supported by the fund's existing custodian. A crypto asset rule should provide flexibility for funds not only to receive such assets, but also to provide for workable, temporary custody solutions if the asset is not already supported by a fund's custodian.

OTHER CONSIDERATIONS

Registration under the 1940 Act

Under current law and Commission interpretations, funds whose portfolios consist of all or substantially all crypto assets are generally not eligible to register as an investment company with the Commission. As a matter of policy, funds that hold crypto assets should be able to opt-in to registration as registered investment companies because such registration provides a framework for investor protection, including disclosure requirements, governance standards, and fiduciary duties. By opting into this framework, crypto asset funds would enhance transparency and accountability, thereby safeguarding investors and promoting market integrity. Additionally, registered investment companies are subject to Commission oversight, which includes regular reporting and compliance checks. This oversight could help mitigate risks associated with crypto assets, such as volatility and security concerns, by ensuring that funds adhere to established standards and practices. Registration would also lend legitimacy to crypto asset funds, potentially increasing investor confidence and participation in the crypto markets, facilitating the growth and maturation of the crypto asset sector within the broader financial ecosystem. Allowing crypto asset funds to opt-in would align them with these existing products, creating consistency in regulatory treatment and investor expectations.

While the Commission has the authority to implement some opt-in registration for crypto asset funds through interpretive guidance, there are limits to this approach. Section 3(a) of the 1940 Act defines an investment company as one that "is engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." Although the term "securities" is broadly defined under federal securities laws and can encompass certain crypto assets, particularly those functioning as investment contracts or resembling traditional securities, most crypto assets do not fit neatly within this definition. The Commission's ability to issue guidance may not cover all crypto asset-holding funds, especially those dealing with crypto assets that are commodities or that otherwise do not clearly fall under the existing securities framework.

Given these limitations, the Commission should consider advocating to Congress for amendments to the 1940 Act that explicitly allow crypto asset-holding funds to opt-in to investment company registration. Legislative amendments would provide a clear and comprehensive framework for the inclusion of crypto assets, ensuring that all relevant funds can benefit from the investor protections and regulatory oversight associated with registered investment companies. By working with Congress, the Commission can help establish a robust regulatory environment that accommodates the unique characteristics of crypto assets while maintaining the integrity and stability of the financial markets.

Tax Treatment of Crypto Funds

Allowing crypto asset funds to register under the 1940 Act would also enable such funds to potentially qualify as "regulated investment companies" (*"RICs"*) under Subchapter M of the Internal Revenue Code of 1986 (the *"Code"*). Under Section 851 of the Code, a RIC must derive at least 90% of its gross income from certain qualifying sources, such as dividends, interest, and gains from the sale of securities. Income from the sales of crypto assets is typically not qualifying income for purposes of this test. Therefore, in order for eligible funds to qualify as RICs, they must either limit their exposure to crypto assets so as to satisfy the qualifying income test or create holding structures to change the character of the income derived from the crypto assets. For example, many funds that invest in assets that produce non-qualifying income will create wholly-owned offshore subsidiaries that hold the assets, which changes the character of the income derived from such assets under the Code. However, because of the asset diversification requirements of Section 851 of the Code, a fund that employs such structures is typically limited to such offshore subsidiaries representing no more than 25% of the fund's assets. As a result, registered investment companies that seek to hold crypto assets typically must choose between taxation as a RIC or obtaining the desired level of exposure to crypto assets.

We encourage the Commission, together with the Internal Revenue Service, to advocate for amendments to the Code that would allow income derived from crypto assets, as well as derivative instruments on crypto assets, to be treated as qualifying income under Section 851 of the Code. The current exclusion of crypto assets from qualifying income creates unnecessary complexity and uncertainty for investment companies. By amending the Code, Congress can simplify tax compliance and reduce administrative burdens, allowing registered investment companies to focus on strategic growth and investment. Incorporating income from crypto assets as qualifying income for RICs under the Code is a necessary step to modernize tax regulations. This change would reflect the economic significance of crypto assets, align with investment trends, ensure regulatory consistency, encourage innovation, and mitigate tax complexity. As the financial landscape continues to evolve, it is crucial that the Code evolves with it to innovations in the digital asset industry.

CONCLUSION

The current custody requirements under the 1940 Act present significant and multifaceted challenges for funds seeking to invest in crypto assets. The statutory and regulatory framework was designed for traditional securities and does not adequately address the unique characteristics, risks, and operational realities of digital assets. To enable registered investment companies to participate responsibly in the evolving crypto asset ecosystem while maintaining robust investor protections, the Commission should provide interpretive guidance in the short term and propose and adopt new rules as necessary in the longer term to:

- Clarify the eligibility of custodians, including state-chartered trust companies and other prudentially regulated entities;

- Define custody in the context of digital assets, focusing on possession or control of private keys;

- Develop a crypto asset-specific custody rule that addresses the operational realities of digital asset custody; and

- Emphasize investor disclosure, board oversight, and liquidity safeguards, rather than attempting to fit novel digital asset activities into an outdated custody framework.

By taking these steps, the Commission can foster innovation, enhance investor protection, and ensure that registered investment companies are able to participate in the crypto asset markets in a safe, secure, and compliant manner.

TDC acknowledges the significant efforts of Morrison Warren, Jim Audette, and Kathryn Maass of Chapman and Cutler LLP toward the preparation of this letter. TDC also thanks the many members who contributed their time and expertise toward the development of this letter, including but not limited to Gregory S. Collett, General Counsel, Rex Financial and Kelley A. Howes, Partner, Morrison and Foerster.

If you have any comments or questions relating to the request or would like to arrange a meeting to discuss further, please do not hesitate to contact the undersigned at (312) 845-3484 or warren@chapman.com.

Very truly yours,

CHAPMAN AND CUTLER LLP

By ______________________
Morrison C. Warren

Cc: Cody Carbone, Chief Executive Officer, The Digital Chamber
Annemarie Tierney, Senior Strategic Advisor, The Digital Chamber
James M. Audette, Chapman and Cutler LLP
Kathryn Maass, Chapman and Cutler LLP