

Verady, Inc.
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May 31, 2019

Paul G. Cellupica
Deputy Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE, Washington, D.C. 20549-1090

Re: Engaging on Non-DVP Custodial Practices and Digital Assets | Investment Advisers Act of 1940: Rule 206(4)-2 (the “**Custody Rule**”) | Letter to Karen Barr, President & CEO, Investment Adviser Assn., March 12, 2019 (the “**Letter**”)

Dear Mr. Cellupica:

We appreciate the opportunity to engage with you on how digital asset characteristics impact application of the Custody Rule. Because Verady, Inc. is a blockchain asset accounting, reporting and verification company, we focus our input on the role of independent verification of client assets, both in the history and purpose of the Custody Rule and in the tools and services now available for digital assets.¹

The Custody Rule mandates key safeguards for registered investment advisers with custody of client funds and securities. Its purpose is to protect advisory client assets from misuse or misappropriation. Modern custodial practices have necessitated rule changes and a large number of staff no-action letters since the rule was first adopted in 1962 when “paper-based systems of owning and holding securities” were prevalent.² Despite its long history and many complexities in application of the Custody Rule,³ several of its safeguards simply prescribe the controls and tools (and the frequency of their use) to independently verify funds and securities within the custody of the investment adviser – in other words, how and when there must be “another set of eyes on client assets.”⁴ The Custody Rule’s prescriptive approach contrasts with other overlapping obligations an investment adviser has to adopt safeguards, which tend to place the burden on the adviser to develop an appropriate program addressing key elements.⁵

Regardless which the approach the Commission chooses to pursue in Custody Rule revisions or relief, it is critical to recognize that digital assets have characteristics which allow for independent verification of client assets in new and powerful ways. Tools and services exist today which address several investor protection concerns underlying the Custody Rule. For example, Verady’s Ledgible platform allows for, among other things, independent verification of a client’s digital assets with greater frequency and certainty. These practical tools go well beyond verification of the balance of a blockchain address by demonstrating mathematically (*i.e.*, using digital signatures and cryptography) that the entity in question has possession of the private keys to the addresses in which the digital assets reside. Importantly, the verification process and its frequency must strike an appropriate balance between security risks and asset verification. In contrast, an overly simple ‘proof-of-reserves’ process for current public blockchain protocols could compromise security unnecessarily by exposing addresses or keys to the public and allowing third parties (including those exploring opportunities for misappropriation), to track history and movement of digital assets. These verification tools can be used with a number of blockchain protocols and tokens. In short, digital assets have characteristics which allow us to create powerful tools for independent verification of client assets, a critical aspect of the Custody Rule.

We welcome the opportunity to engage further with you and our industry partners on independent verification of funds and securities as you consider the application of the Custody Rule to digital assets.

Sincerely,

Kell Canty, CEO, Verady, Inc.

Cc: Karen L. Barr, President & CEO, Investment Adviser Assn.
Valerie A. Szczepanik, Strategic Hub for Innovation and Financial Technology (FinHub)
Daniel Gorfine, Chief Innovation Officer & Director, LabCFTC
Ron Quaranta, Founder & Chairman, Wall Street Blockchain Alliance
John D’Agostino, Founder, DMS Digital Assets Working Group

End Notes:

¹ In addition to independent verification of assets, other key Custody Rule controls address separation of client funds and securities. For instance, a registered investment adviser with custody must maintain those funds and securities with a qualified custodian in a separate account for each client under that client's name or in accounts that contain only clients' funds and securities, under the adviser's name as agent or trustee for the client.

² *Regulation of Custodial Practices Under the Investment Advisers Act of 1940 Rule 206(4)-2*, Investment Adviser Association, Investment Adviser Compliance Conference 2014, Robert E. Plaze.

³ Few would disagree that it can be complex to apply the Custody Rule to an adviser's situation. In addition, the Custody Rule has featured prominently in common deficiencies identified by the SEC's Office of Compliance Inspections and Examinations. For example, see *Significant Deficiencies Involving Adviser Custody and Safety of Client Assets*, SEC National Exam Program Risk Alert, Volume III, Issue 1 (March 4, 2013), available at <http://www.sec.gov/about/offices/ocie/custody-risk-alert.pdf>.

⁴ See *Footnote 2*. Many investment advisers with custody fulfill custody requirements for private investment funds primarily by (1) placing client funds and securities with a 'qualified custodian' who maintains assets in a separate account for each client (see above); (2) making appropriate custody disclosures in Form ADV and having compliance policies and procedures to address custody; and (3) providing investors with annual audited financial statements prepared in accordance with GAAP. Some other investment advisers with custody who cannot rely on the so-called 'audit approach' comply with other third-party verification controls and tools which vary according to the situation, such as (a) notifying clients how and where client assets are being held, (b) ensuring qualified custodians send account statements directly to clients at least quarterly and (c) undergoing an annual surprise examination by an independent public accountant.⁴ In addition, many fund managers are not required to maintain certain 'privately offered securities' with a qualified custodian if the fund's financial statements are audited and certain other requirements are met. Further, an adviser is required to obtain an internal controls report from a PCAOB accountant and satisfy other requirements if the qualified custodian is the adviser or a 'related person' of the adviser who maintains adviser client assets. An example of an internal controls report is available from Association of International Certified Professional Accountants (AICPA).

⁵ For instance, the Safeguards Rule of Regulation S-P requires registrants to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. See OCIE Risk Alert, *Investment Adviser and Broker-Dealer Compliance Issues Related to Regulation S-P – Privacy Notices and Safeguard Policies*, April 16, 2019. Similarly, OCIE has provided guidance on procedures and controls surrounding cybersecurity preparedness. See OCIE Risk Alert, *Observations from Cybersecurity Examinations*, August 7, 2017. In addition, the SEC's compliance rule 206(4)-7 and guidance addresses, among other things, areas in which registered investment advisers must adopt written policies and procedures reasonably designed to prevent compliance violations.