May 8, 2023

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

Re: Safeguarding Advisory Client Assets, Proposed Rule 223-1

Dear Ms. Countryman:

Coinbase Global, Inc. ("**Coinbase**") is filing this comment in response to the Commission's February 15, 2023 proposal to update the investment adviser custody rule ("**Proposal**" or "**Proposed Rule**").[1] Coinbase applauds the Commission's use of notice and comment rulemaking and welcomes the chance to comment on the Proposal. The Proposal would prescribe a number of best practices that Coinbase, as an industry leader, already employs. These include holding assets in bankruptcy-remote accounts and obtaining insurance to protect client assets, among others.

While we agree with some of the measures outlined in the Proposal, we are concerned that, in its current form, the Proposal makes unwarranted assumptions about custodial practices based on the Commission's experience with securities. These assumptions are not necessary or appropriate, and could be detrimental to consumer protection for other asset classes, including crypto assets (whether or not they are securities).[2] To address these issues and fulfill the Commission's mission to protect investors, maintain efficient markets, and facilitate capital formation, the Commission should make substantial changes to the Proposal. If the Proposal is adopted, the Commission should also revise or rescind certain staff guidance the Proposal would render obsolete. Were the Commission to revise the Proposal and related staff guidance, as discussed in more detail below, we would support the Proposal.

A. About Coinbase

Coinbase was founded in 2012 as a consumer platform making it easy to purchase, sell, and transact in crypto assets. Our business was founded on the premise that crypto—and the open, global network upon which it is built—creates unprecedented opportunities to accelerate innovation across the global financial services sector and beyond. Coinbase was among the first regulated crypto exchanges in the United States and today our global operations are regulated under a number of regimes, including federal futures and investment advisory rules, as well as state money transmission, lending, and virtual currency regulations like New York's BitLicense.

Over the past decade, we have participated in the tremendous growth of blockchain protocols and crypto assets. In 2021, Coinbase became the first major crypto company to list on a U.S. stock exchange. Today, we operate the largest crypto exchange in the United States, and one of

[1] SEC, *Safeguarding Advisory Client Assets*, Advisers Act Rel. No. 6240, 88 FR 14672 (Mar. 9, 2023).

[2] The Commission has at various points used the terms "digital assets" or "crypto assets" to refer to assets issued via blockchain whether such assets are securities or not. The Proposal uses the term "crypto assets" and so we will use this term below unless citing a document where a different term is employed.

the largest in the world. We support millions of users across more than 100 countries who, in 2022, traded over $830 billion in crypto assets on our platform.[3]

Coinbase owns and operates Coinbase Custody Trust Company, LLC ("**Coinbase Custody**"),[4] a New York-chartered trust company, as a qualified custodian for our registered investment adviser ("**RIA**") clients. Coinbase safeguards client assets using a combination of legal and technological controls designed to ensure bankruptcy remoteness and protect against cyber threats. These measures, not required under current rules, have allowed us to be the trusted qualified custodian of some of the largest asset managers in the world, including roughly 25 percent of the largest 100 hedge funds.[5]

B. Summary

The Proposal expands the scope of RIA custody obligations from "funds and securities" to all client assets. However, the Proposal does not adapt its requirements to account for that change. To ensure the new expanded custody obligations are "evergreen" to encompass new types of investments, the Commission should make a number of revisions to the Proposal, while foregoing certain changes the Proposal appears to contemplate.

1. The Commission should retain state-regulated trust companies as qualified custodians.

Coinbase was pleased to see that state trust companies like Coinbase Custody would remain qualified custodians under the Proposal. The Commission requested comment on whether to narrow the types of banks allowed to serve as qualified custodians to only include those "subject to Federal regulation and supervision." We strongly disagree and believe the Commission should continue to recognize state trust companies and other state-regulated financial institutions as qualified custodians. State financial regulators are often more nimble than their federal counterparts in response to technological and economic changes. Moreover, Congress has consistently promoted a dual-regulatory system for banks codified in the Advisers Act. Were the Commission to require all qualified custodians to be federally regulated, it would contravene long-standing Congressional and Commission policy that state and federally regulated qualified custodians are equivalent.

The Proposal contains no policy explanation or economic analysis that would support making a change to the scope of banks eligible to serve as qualified custodians. If the Commission pursued such a course, it would constitute a major rule and require considerably more justification, assessment of alternatives, and cost-benefit analysis than the Proposal. Therefore, if the Commission wants to consider revising the qualified custodian definition to exclude state-regulated banks, it would first have to issue a revised proposal explaining why doing so would promote competition, capital formation, and investor protection. Otherwise, removing state-regulated banks as qualified custodians would be arbitrary, capricious, and contradict Commission statutory rulemaking requirements.

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[3] *See* Coinbase, *Form 10-K 2022 Annual Report*, at 99 (Feb. 23, 2023), available at https://d18rn0p25nwr6d.cloudfront.net/CIK-0001679788/86fe25e0-342b-40fa-aacc-ea04faf322cb.pdf.

[4] N.Y. Department of Financial Services, *DFS Authorizes Coinbase Global, Inc. to Form Coinbase Custody Trust Company LLC* (Oct. 23, 2018), available at https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1810231; N.Y. Banking Law § 102-a (authorizing limited liability trust companies).

[5] Coinbase, *Shareholder Letter: Fourth Quarter and Full-Year 2022*, at 3 (Feb. 21, 2023), available at https://s27.q4cdn.com/397450999/files/doc_financials/2022/q4/Shareholder-Letter-Q4-2022.pdf.

2. ***The Commission should allow RIA client assets limited exposure to non-qualified custodian environments.***

The Commission should revise the Proposal to allow RIA client assets to temporarily leave the qualified custodian so RIAs can execute and settle trades within T+1 consistent with recent Commission rule amendments. The Proposal requires qualified custodians to maintain possession or control of RIA client assets at all times. The Commission uses the requirement to justify banning RIA client trades on crypto exchanges that are not qualified custodians and require pre-funding to execute transactions. This restriction on crypto asset trading does not account for why crypto exchanges pre-fund transactions or the benefits of pre-funding such as real-time settlement. Moreover, requiring RIA client transactions to clear and settle inside a qualified custodian would not provide any material benefits to those clients because non-qualified custodian trading platforms like Coinbase's exchange safeguard client assets using the same technology as their affiliated qualified custodians.

The absence of a provision allowing transfers outside a qualified custodian could also harm traditional markets by prohibiting or complicating the ability of Commission-registered clearing agencies to clear and settle transactions for RIA clients, contravening the Commission's in-transit rules for broker-dealers, and potentially restricting anti-money laundering and sanctions checks. Instead, the Commission should interpret the requirement to maintain assets with a qualified custodian to allow for short periods of exposure to non-qualified custodian entities. To conform this exposure to recently adopted Commission rules, this period could be set at 24 hours or one business day. This interpretation would allow RIAs to trade and settle transactions on behalf of clients in both crypto and traditional assets, limiting exposure to potential risks while realizing the benefits of shorter settlement periods.

3. ***The Commission should allow standards of care, indemnification, and insurance requirements to be tailored by asset class.***

The Commission should modify the Proposal to interpret "adequate insurance" as insurance arrangements that are reasonably available to qualified custodians by asset class and clarify that such insurance need not fully indemnify RIA clients. The Commission should also allow custodial standards of care to be tailored by asset class and consider requiring RIAs or custodians to disclose the custodial risks associated with different asset classes. The Proposal would require RIAs to obtain written assurances from qualified custodians that they would indemnify RIA clients for losses caused by custodian negligence and have insurance arrangements to "adequately protect" RIA clients from such losses. It is currently uncommon for custodians to indemnify their clients and requiring such indemnification against a full risk of loss would materially change the economics of custodial relationships. The Proposal also does not define what insurance would be adequate, suggesting the Commission has unstated expectations that could be unattainable in the insurance market. Finally, the Proposal assumes the custodial standard of care often used for funds and securities is also appropriate for all other asset classes, but does not adequately explain why it makes this assumption. This assumption is unfounded and legal uncertainty surrounding standards of care for other asset classes will likely substantially increase costs to RIA clients or preclude them from investing in certain asset classes altogether.

4. The Commission should allow sophisticated investors to negotiate their own custodial arrangements.

The Commission should modify the Proposal so that the reasonable assurances, including those for standards of care and insurance arrangements, only apply to RIA clients that are not in a position to negotiate the terms of their custodial agreements. The Proposal does not distinguish between different types of RIA clients. This means that RIAs only serving highly sophisticated institutional investors must ensure their clients enter custody agreements on substantially the same terms as those serving retail investors. Without this distinction, the Proposal would prevent sophisticated investors from negotiating the terms of their custodial contracts. However, these investors are far better suited than the Commission to assess the trade-off between custodial costs and risk of loss. The Commission should therefore also revise the Proposal to ensure the reasonable assurances, including those for standards of care and insurance arrangements, only apply to RIA clients that are not in a position to negotiate the terms of their custodial agreements.

5. The Commission should revise the Proposal to allow RIA custody in additional circumstances.

The Commission should expand the exception allowing RIAs to custody physical assets and certain private securities to include any asset the RIA is unable to maintain at a qualified custodian. Like the current rule, the Proposal requires RIAs to hold client assets at a qualified custodian subject to limited exceptions. The Proposal narrows these exceptions to only physical assets and a limited set of private securities. By limiting the qualified custodian exception in this way, the Commission would effectively ban RIA clients from investing in asset classes that cannot be held at a qualified custodian, including early-stage crypto tokens. Such a ban, unaccounted for in the Commission's cost-benefit analysis, would exceed the intent of the Advisers Act's safeguarding provision,[6] which does not authorize the Commission to ban RIAs from investing client assets in particular asset classes. Moreover, the narrow exceptions in the Proposal do not account for the benefits of blockchain technology or crypto asset market practices. These benefits include the ability to avoid the use of costly intermediaries and to protect client assets by holding them in off-platform cold storage verifiable through blockchains until the RIA needs to trade them. The current Proposal would prohibit these practices without any attendant benefits to RIA clients. The Commission could avoid these issues by simply expanding the qualified custodian exception to include any asset unable to be maintained at a qualified custodian.

6. The Commission should adopt a unified possession or control standard to allow consumers to hold crypto assets at a broader range of qualified custodians.

The Commission should clarify that the Proposal's interpretation of "possession or control" also applies to broker-dealers by rescinding staff guidance requiring them to demonstrate *exclusive* possession or control to custody crypto assets. The Proposal's definition of possession or control turns on whether a qualified custodian is required to participate in beneficial ownership changes of a particular asset, not whether it can demonstrate "exclusive" possession or control. Demonstrating exclusive possession or control is impossible, even for traditional assets, because it requires proving a negative. Broker-dealers should custody crypto assets under the

[6] Advisers Act § 223 (codified at 15 USC § 80b-18b) ("An [RIA] shall take such steps to safeguard client assets over which such [RIA] has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe" making no mention of banning particular investments by RIA clients).

same requirements as other asset classes. Failing to rescind the staff guidance would subject broker-dealers to a higher custodial standard for crypto assets than other types of qualified custodians, such as banks and foreign financial institutions. The Commission should adopt a technology and entity neutral stance towards crypto assets by allowing broker-dealers to custody these assets under a similar possession or control standard as set forth in the Proposal. To do this, the Commission should extend the Proposal's possession or control interpretation to broker-dealers and rescind staff guidance imposing the exclusivity standard.

7. ***The Commission should modify the Proposal's external reconciliation requirements to allow qualified custodians to use the best available data.***

The Commission should modify the Proposal to exempt assets not held in layered custodial relationships from the Proposal's external reconciliation requirement or clarify that external reconciliation may be conducted using the best available data sources, even if those sources are not qualified custodians. The Proposal would require qualified custodians to obtain internal control reports from an independent auditor. When a qualified custodian is affiliated with the RIA, the Proposal would require the auditor to verify client assets are reconciled to a custodian other than the RIA or its affiliate. This requirement makes sense when assets are held in layered custodial relationships, *i.e.,* when there are multiple levels of custodians, as is the case for funds and securities. However, the requirement does not make sense when such relationships are absent, such as for crypto assets where control of an asset is ultimately determined by a blockchain. To account for the differences among asset classes, the Commission should either exempt assets, including crypto assets, not held in layered custodial arrangements from the external reconciliation requirement, or clarify that external reconciliation may be conducted using the best available data sources, such as blockchains for crypto assets.

8. ***The Commission should direct the staff to revise its accounting guidance to account for the Proposal's enhanced custody protections.***

In addition to revising the Proposal, as discussed above, the Commission should also revise staff guidance the Proposal would render obsolete. This includes staff accounting guidance currently making it non-economical for traditional financial institutions to custody crypto assets. Last year, the staff issued Staff Accounting Bulletin 121, without any notice or comment. This "guidance" requires public companies, including traditional financial institutions, to record crypto assets on their balance sheets, regardless of how they are held. When issuing this guidance, the staff cited a need to mitigate legal uncertainty surrounding crypto assets, and in particular bankruptcy treatment. The Proposal obviates such uncertainty for qualified custodians by requiring them to hold RIA client assets in bankruptcy-remote accounts. Therefore, the Commission should direct the staff to modify its accounting guidance to account for these changes, thereby allowing public companies, including banks, to hold crypto assets without recording those assets on their balance sheets.

Coinbase appreciates the opportunity to comment on the Proposal and would welcome discussions with the Commission or staff to clarify any of the points raised in this letter.

C. About Crypto

Every day, we rely on third parties to protect and verify valuable information (financial, medical, personal, etc.). This allows us to know who owns what, and who has the requisite qualifications

to, for example, drive, fill prescriptions, or enter buildings. In 2008, the Bitcoin whitepaper[7] demonstrated how valuable information could be stored, transferred, or used with blockchains rather than third parties. This insight spawned a $1 trillion industry that will continue to revolutionize recordkeeping, value transfer, and other functions yet to be determined.

A “blockchain” is a list of accounts and transactions connected by advanced cryptography. When someone transfers value or shares information, blockchains record those transactions in a block and append them, along with others, to previous blocks forming a chain of blocks, *i.e.*, a blockchain. Blockchains use software distributed across computer networks rather than centralized corporate entities to store and verify information. This architecture means that no one person owns or controls the largest blockchains; they simply run on their own the same way a home computer does without most users writing any software.

Software designed for blockchains (often called “protocols”) is pre-programmed with incentives to allow economic forces rather than human decisions to operate the software. To do this, most protocols issue tokens (often called “digital assets,” “cryptocurrency,” or just “crypto”) that act as a medium through which those economic forces work. This is radically different from centrally planned apps on a phone or laptop that often require thousands of engineers to develop and maintain. By relying on economic forces rather than central planning, blockchain protocols promise to revolutionize many industries over the coming decades, starting with finance.[8]

D. The Commission should retain state-regulated trust companies as qualified custodians.

The Proposal recognizes the fact that state-regulated trust companies like Coinbase Custody are qualified custodians, but asks for comment on whether the definition should be narrowed to banks subject to federal regulation. The Commission should continue to recognize state trust companies and other state-regulated financial institutions as qualified custodians. State financial regulators are often more nimble than their federal counterparts in response to technological and economic changes. Thus, including them as a class of qualified custodians promotes competition, efficiency, and investor protection. Moreover, Congress has consistently promoted a dual-regulatory system for banks codified in the Advisers Act. Were the Commission to require all qualified custodians to be federally regulated, it would contravene long-standing Congressional and Commission policy that state and federally regulated qualified custodians are equivalent. Although the Proposal asks whether the rule should change, it contains no explanation or economic analysis evaluating the effects of such a change. Moreover, such a change would clearly constitute a major rule.[9] Therefore, before adopting any revision to the qualified custodian definition to exclude state-regulated banks, the Commission would have to issue a revised proposal explaining why doing so would promote competition, capital formation, and investor protection. Otherwise, removing state-regulated banks as qualified custodians would be arbitrary, capricious, and contradict Commission statutory rulemaking requirements.

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[7] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (Oct. 31, 2008), available at https://bitcoin.org/bitcoin.pdf.

[8] For example, to match, clear, and settle securities trades, Nasdaq and the Depository Trust Clearing Corporation collectively employ over 10,000 people. *See* Nasdaq, *Form 10-K 2022 Annual Report*, at 15 (Feb. 13, 2023), available at https://ir.nasdaq.com/static-files/da430261-fbe2-4619-a114-00f5706672d9; DTCC, *Press Release: DTCC Named to the Forbes Best Employers List* (Jul. 16, 2018), available at https://www.dtcc.com/news/2018/july/16/dtcc-named-to-the-forbes-best-employers-list. By comparison, Uniswap Labs has developed a blockchain protocol that accomplishes these functions with less than 100 employees. *See* Uniswap Labs, *LinkedIn Page* (Jun. 2022), available at https://www.linkedin.com/company/uniswaporg.

[9] 5 USC § 804(2) (defining “major rule”).

The Custody Rule defines "qualified custodians" to include banks as defined in the Advisers Act.[10] The Advisers Act, in turn, defines "banks" to include federally chartered banks, Federal Reserve members, and state-chartered financial institutions, including trust companies, provided they receive deposits or exercise fiduciary powers similar to national banks as a substantial part of their business.[11] The Proposal retains the current definition of "bank" with a new provision requiring banks to hold client assets in bankruptcy-remote accounts. However, in the Proposal, the Commission specifically requested comment on whether the Proposal should narrow the definition of "bank" to only include banks "subject to Federal regulation and supervision."[12] As will be discussed in more detail below, it should not.[13]

For over a century and a half, Congress has consciously implemented and preserved a parallel system of state and federal regulation for banks called the "dual-banking system."[14] Through this system, Congress sought to create a "competitive equality between state and national banks."[15] Congress expressed this intention in the Advisers Act where it was careful to preserve the traditional roles of state financial regulators.[16] Custody of financial assets for RIA clients, including crypto assets, constitutes a core banking activity the dual-banking system's Congressional design, as expressed in the Advisers Act, was intended to address.[17] Thus, any attempt to exclude state-regulated banks from providing custodial services allowed for federally regulated banks, would contravene longstanding Congressional intent.[18]

The Commission has also long treated state and federally regulated financial institutions as equivalent under its rules. Since the inception of the Custody Rule in 1962, the Commission has required RIAs to hold client funds at banks, without regard to their charter or whether they were federally regulated.[19] Moreover, when adopting the qualified custodian requirement in 2003, the Commission acknowledged it defined the term to capture "financial institutions that clients and advisers customarily turn to for custodial services … includ[ing] banks," again, without regard to

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[10] 17 CFR § 275.206(4)-2(d)(6)(i).

[11] 15 USC § 80b-2(a)(2).

[12] Proposal at 14685 (Question 19).

[13] Throughout this section, we use the term "state-regulated bank" to refer to state-chartered banks, as defined in the Advisers Act, that are not federally regulated.

[14] Julie Stackhouse, *Why America's Dual Banking System Matters*, Fed. Reserve. Bank of St. Louis: On The Economy Blog (Sep. 18, 2017), available at https://www.stlouisfed.org/on-the-economy/2017/september/americas-dual-banking-system-matters.

[15] *First Nat. Bank of Logan, Utah v. Walker Bank & Tr. Co.*, 385 U.S. 252, 255 (1966).

[16] *See e.g.*, 15 USC § 80b-3a(b)(2) (provision stating the Advisers Act should not be read to prohibit state securities regulators from investigating or enforcing against RIA fraud); 15 USC § 80b-18a(a) ("Nothing in [the Advisers Act] shall affect the jurisdiction of the [state regulators] over any security or any person insofar as it does not conflict with the [Advisers Act]"). Congress also expressed this intention in the other federal securities laws. *See e.g.*, 15 USC § 78c(a)(6) (Exchange Act defining "bank" essentially the same as the Advisers Act).

[17] *See* OCC, *Interpretive Letter #1170: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers* (Jul. 22, 2020) ("The OCC concludes … that providing cryptocurrency custody services, including holding the unique cryptographic keys associated with cryptocurrency, is a modern form of these traditional bank activities"), available at https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf.

[18] *See Gregory v. Ashcroft*, 501 U.S. 452, 461 (1991) ("Congress should make its intention 'clear and manifest' if it intends to pre-empt the historic powers of the States") (internal quotation marks omitted).

[19] *See* SEC, *Custody or Possession of Funds or Securities of Clients*, Advisers Act Rel. No. 123, 27 Fed. Reg. 2150 (Mar. 6, 1962) (making no distinction between state and federally regulated banks).

whether they were federally regulated.[20] The Commission has also taken this approach for broker-dealers who are authorized to hold customer assets at good control locations, including state or federally regulated banks.[21] Thus, were the Commission to exclude state-regulated banks from the definition of "qualified custodian," it would upend more than 60 years of Commission policy treating state and federally regulated banks as equivalent without justification.

In light of clear Congressional intent to maintain the dual-banking system and longstanding Commission policy to treat state and federally regulated banks as equivalent, it is unclear why the Commission would consider limiting qualified custodian status to federally regulated banks. The Proposal says almost nothing about why the Commission believes such a change could be appropriate. If the Commission believes state-regulated banks pose unique risks to RIA clients as compared to their federal counterparts, no basis has been established for that belief. State-regulated banks have custodied RIA client assets for decades and the Commission has not cited any example showing they have failed to do so reliably.

The only potential justification for such an exclusion alluded to in the Proposal is a purported need to protect client assets in the event a custodian becomes insolvent.[22] However, that is no reason to exclude state-regulated banks from qualified custodian status. State regulators are often well *ahead* of federal regulators in establishing safeguards to protect client assets in the event of insolvency, especially for crypto assets. For example, Coinbase Custody operates subject to stringent supervision by New York's Department of Financial Services ("**NYDFS**"). NYDFS has crafted a rigorous framework tailored specifically to custodians of crypto assets.[23] These requirements include a review of a custodian's digital-wallet environment, capitalization, anti-money laundering procedures, and storage architecture for compliance with strict technical, operational, and governance requirements. Coinbase Custody must also maintain client assets in segregated accounts—either through: (i) separate on-chain wallets and internal ledger accounts for each customer; or (ii) one or more omnibus on-chain wallets and internal ledger accounts containing only a specific client's assets.[24] In addition, unlike many federally chartered institutions, many state-chartered banks are subject to insolvency regimes that contain express protection for custodied assets.[25] Thus, holding crypto assets in state-regulated banks may be safer than at federally regulated banks lacking similar crypto asset tailored requirements.

Like other federal agencies, the Commission has an Administrative Procedure Act ("**APA**") obligation to promulgate rules pursuant to notice and comment.[26] This includes an obligation to "expos[e]" to the public any facts and information a person reasonably needs in order to offer

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[20] *See* SEC, *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2176, 68 FR 56691, at 56693 (Oct. 1, 2003); *see also* SEC, *Custody of Funds or Securities of Clients by Investment Advisers*, Advisers Act Rel. No. 2968, 75 FR 1455, at 1456 (Jan. 11, 2010) (reaffirming this intent).

[21] *See* 17 CFR § 240.15c3-3(c)(5) (including banks, as defined in the Exchange Act, as good control locations); 15 USC § 78c(a)(6) (Exchange Act defining "bank" include both state and federally regulated financial institutions).

[22] Proposal at 14685.

[23] *See* 23 CRR-NY Pt. 200 (Virtual Currencies).

[24] *See generally* NYDFS, *Guidance on Custodial Structures for Customer Protection in the Event of Insolvency* (Jan. 23, 2023), available at https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures.

[25] *See e.g.*, N.Y. Bank. L. § 617.

[26] 5 USC § 553.

"useful criticism" of a proposal.[27] This obligation is amplified by the Advisers Act, which requires the Commission to address costs and benefits of rule changes with respect to "efficiency, competition, and capital formation."[28]

The Commission's suggested exclusion of state-regulated institutions would adversely affect "efficiency, competition, and capital formation." As the Commission acknowledges in the Proposal, the custodial-services industry is "dominated by a small number of large market share participants."[29] This is especially true for crypto asset custodians. Per the Commission, at present, "one OCC-regulated national bank, four OCC-regulated trusts, approximately 20 state-chartered trust companies and other state-chartered, limited purpose banking entities, and at least one [futures commission merchant] offer custodial services for crypto assets."[30] Narrowing the definition of "qualified custodian" could thus have potentially disastrous effects for competition, reducing the number of crypto asset qualified custodians by as much as 77 percent. The reduced competition likely would slow innovation in this space while impairing the efficiency of the market for crypto asset custodial services as a whole.

Removing state-regulated banks as qualified custodians would not just undermine competition, it would leave RIAs with billions in assets to relocate while simultaneously limiting the number of reliable custodians at which to keep them. That, in turn, would impair capital formation by dislocating billions of dollars in crypto assets that have been custodied at state-regulated banks for years.

Most importantly, the Commission's suggested exclusion would harm investors by removing access to institutional-grade crypto asset custody solutions, as the Commission itself has recognized. As discussed in more detail below, the Proposal would prohibit RIA self-custody of crypto assets, even when it would be impossible for a qualified custodian to provide custody services for such assets. Were the Commission to also exclude state-regulated banks from holding RIA client crypto assets, it would exclude Coinbase Custody and others that have developed cutting-edge technology to safeguard and segregate these assets.[31] Without institutional-grade custodians like Coinbase Custody, RIA clients would be left to fend for themselves, unnecessarily exposing them to cyber threats, fraud, and other risks institutional custodians solve for. The Commission itself has recognized this, stating the Proposal "could cause investors to remove their assets from an entity that has developed innovative safeguarding procedures for those assets, possibly putting those assets at a greater risk of loss."[32] Thus, the suggested change would not benefit investors.

To prevent these significant harms to efficiency, competition, capital formation, and investors, as well as to advance the Congressional dual-banking system policy, the Commission should continue to recognize state-regulated banks as qualified custodians. Moreover, the APA and the Advisers Act require the Commission "to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation before it decides

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[27] *See Am. Radio Relay League v. FCC*, 524 F.3d 227, 236 (D.C. Cir. 2008).

[28] 15 USC § 80b-2(c).

[29] Proposal at 14737.

[30] Proposal at 14739-14740.

[31] *See* Coinbase, *Custody Rule and Digital Assets*, at 6 (May 25, 2021), available at https://www.sec.gov/files/coinbase-052521.pdf.

[32] Proposed Rule at 14742.

whether to adopt the measure."[33] Under these statutes, the Commission must publicly display the materials informing the "basic assumptions" it used to consider the costs of a rule *at the proposal stage*.[34] Asking whether to limit banks that can serve as qualified custodians to only federally regulated institutions suggests the Commission is considering a significant rule change without engaging in the appropriate analysis, notice, and comment required by the Advisers Act and the APA. If the Commission intends to consider such a radical change, it must do so by issuing a revised proposal.

E. The Commission should allow RIA client assets limited exposure to non-qualified custodian environments.

The Commission should tailor the final rule to allow RIA client assets to temporarily leave the qualified custodian so RIAs can execute and settle trades within T+1 consistent with the Commission's recent amendments to Rule 15c6-1.[35] Proposed Rule 223-1 requires qualified custodians to maintain possession or control of RIA client assets. The Commission appears to interpret the word "maintain" to require client assets to remain within a qualified custodian at all times. From this interpretation, the Commission concludes RIAs could not pre-fund client trades on platforms that are not qualified custodians, even for short periods of time, because pre-funding would take client assets out of a qualified custodian during the pre-funding period, thus violating the rule.[36]

This requirement applies novel treatment to crypto assets without accounting for why crypto exchanges pre-fund transactions. As we mentioned in our petition[37] last year, one of the central innovations of blockchain technology is the ability to execute transactions 24 hours a day, seven days a week, settling in real-time. As the Commission has long acknowledged, including in its recent proposal to reduce the settlement cycle to T+1[38] and the T+1 Adopting Release, time equals risk and therefore less time between a transaction and its completion protects investors, reduces risk in the financial system and increases operational efficiency in markets.[39] In crypto asset markets, real-time settlement is possible because trading, clearing, settlement, and custody can be provided effectively and efficiently by a single entity. In some cases, this entity is a qualified custodian. In others, it is not. The difference often has to do with state regulatory requirements that do not materially impact the safety of client assets. Were the Commission to require all these activities to take place within a qualified custodian, it would require many crypto exchanges to change the structure of their businesses, subject to state regulatory approvals, without any clear benefit to RIA clients. This is because most crypto exchanges like Coinbase that also operate a qualified custodian safeguard client assets using the same technology as their affiliated qualified custodians.

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[33] *Chamber of Commerce v. SEC*, 412 F.3d 133, 144 (D.C. Cir. 2005).

[34] *Chamber of Commerce v. SEC*, 443 F.3d 890, 901 (D.C. Cir. 2006).

[35] *See* SEC, *Shortening the Securities Transaction Settlement Cycle*, Exchange Act Rel. No. 96930, 88 FR 13872 (Mar. 6, 2023) ("T+1 Adopting Release"). The Commission's compliance date for the amendments to Rule 15c6-1 that will shorten the standard settlement cycle from T+2 to T+1 is May 28, 2024.

[36] *See* Proposal at 14689.

[37] *See* Coinbase, *Petition for Rulemaking – Digital Asset Securities Regulatio*n, at 17 (Jul. 21, 2022), available at https://www.sec.gov/rules/petitions/2022/petn4-789.pdf.

[38] *See* SEC, *Shortening the Securities Transaction Settlement Cycle*, Exchange Act Rel. No. 94196, 87 FR 10436 (Feb. 24, 2022) ("T+1 Proposing Release").

[39] *See* T+1 Proposing Release at 10437; T+1 Adopting Release at 13873.

With this in mind, there is no material benefit to RIA clients in requiring their transactions to be cleared and settled entirely within a qualified custodian, especially when such requirements do not apply to large institutions or retail investors trading for their own account. Coinbase has developed cutting edge key management processes to protect client assets. We use the same key management technology for both our exchange and Coinbase Custody, our qualified custodian.[40] Both our exchange and Coinbase Custody hold customer assets in bankruptcy-remote accounts, and both are supervised by the same regulator (NYDFS) under the same regulatory regime. Thus, there are no meaningful additional protections from requiring transactions to occur inside Coinbase Custody, as a qualified custodian, than by allowing such transactions to be executed on Coinbase's exchange. Rather, the prohibition on pre-funding would simply make investing in or trading crypto assets more difficult, without any attendant benefits to markets or investors.

In addition to the harms the Proposal could cause crypto asset markets, interpreting the requirement for qualified custodians to maintain possession or control of RIA client assets to preclude such assets from ever leaving a qualified custodian could also disrupt settlement practices for traditional securities markets. In these markets, customers typically place orders through a broker-dealer that are executed through an exchange or by a broker-dealer acting as an over-the-counter market center.[41] Executed transactions in these securities are then generally cleared and settled through registered clearing agencies. Clearing agencies may be central counterparties ("**CCPs**") or central depositories ("**CSDs**"). CCPs interpose themselves between counterparties to securities transactions, acting functionally as the buyer to every seller and the seller to every buyer. CSDs operate centralized systems for recording ownership.

In either case, clearing agencies appear to take possession or control, as defined in the Proposal, of client assets thereby causing those assets to leave the qualified custodian. Proposed Rule 223-1 defines "possession or control" to mean holding assets such that the qualified custodian is required to participate in a change in beneficial ownership, participation would effect the change, *and* is a condition precedent to the change. However, when settling traditional securities transactions, clearing agencies generally effect the change in ownership of client assets, not the qualified custodian. Of course, this is not an issue when the clearing agency itself is a qualified custodian.[42] However, many clearing agencies are not qualified custodians and would not be under the Proposal.[43] Therefore, RIA's would be prohibited from executing transactions cleared or settled by those clearing agencies because, like transactions traded and settled on crypto exchanges, the qualified custodian would not satisfy its proposed "possession or control" requirement as part of the clearing agency's settlement process.

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[40] Large institutions trust Coinbase Custody to safeguard their and their clients' assets because of Coinbase's cutting-edge key management processes. We safeguard private keys using a combination of distributed cold-storage and multi-party computation technology. Our cold-storage solution generates private keys to hold client assets using a "key ceremony." The key ceremony involves our dedicated Security Engineering Team using custom laptops in secure locations electromagnetically sealed using a Faraday cage to block electromagnetic signals. Inside the cage, we use customized software to generate keys on computers disconnected from the internet. These keys are then encrypted, split into pieces, and stored in secure storage facilities around the world. Without a sufficient number of human approvers, key pieces, and access to Coinbase's secure signing infrastructure, hostile actors cannot access client assets on our platform.

[41] *See* SEC, *Regulation Best Execution*, Exchange Act Rel. No. 96496, 88 FR 5440, at 5489 (Jan. 27, 2023) (Table 1: Q1 2022 NMS Stock Share Volume Percentage by Market Center Type).

[42] For example, we understand that DTCC holds a state-trust charter such that so long as it complies with the bankruptcy remoteness requirements of the Proposal, trades settled on its books should satisfy the Proposal.

[43] For example, the Options Clearing Corporation, LCH SA, ICE Clear Credit, and ICE Clear Europe Ltd. are registered clearing agencies that provide settlement services but would not satisfy the definition of qualified custodian under the Proposal.

Moreover, interpreting the qualified custodian requirement to require client assets to remain in a qualified custodian at all times negates the widely accepted practice of in-transit or pending transactions. For example, the Commission and the Financial Industry Regulatory Authority ("**FINRA**") explicitly recognize this concept in the broker-dealer Customer Protection Rule and related guidance, which deems transactions "in-transit" between broker-dealers, or between broker-dealers and control locations to remain in the broker-dealer's control.[44] Thus, the Proposal could prohibit RIAs from engaging in transactions that other key Commission rules explicitly allow.

Importantly, financial institutions are legally required to satisfy anti-money laundering ("**AML**") and sanctions requirements.[45] To do this, many financial institutions halt payments and other asset transfers in-flight to perform know your customer checks and sanctions screening. While a transaction is "in-flight," the receiving institution has the power to effect changes in beneficial ownership, not the holding institution. This is because the receiving institution holds the sending institution's transfer message[46] pending AML / sanctions review and can, upon completing that review, effectuate the transfer. In these cases, neither the sending nor receiving institution has "possession or control" over the assets as defined in the Proposal, because the receiving institution effectuates the change in beneficial ownership, while the sending institution holds the assets. Thus, while transactions are in-flight, the client assets underlying those transactions may also leave the qualified custodian in violation of the Proposal.

In summary, the Proposal does not account for why crypto exchanges pre-fund transactions nor does it acknowledge or call into question the benefits of pre-funding, such as real-time settlement and the associated protection against settlement risk. Moreover, requiring RIA client transactions to clear and settle inside a qualified custodian does not provide any material benefits to those clients because non-qualified custodian trading platforms like Coinbase's exchange safeguard client assets using the same technology as their affiliated qualified custodians. This requirement could also harm traditional markets by prohibiting or complicating the ability of Commission-registered clearing agencies to clear and settle transactions for RIA clients, contravene the Commission's in-transit rules for broker-dealers, and prohibit AML / sanctions checks. To avoid these issues, the Commission should interpret the requirement to maintain assets with a qualified custodian to allow for short periods of exposure to non-qualified custodian entities, *i.e.*, "possession or control" by such entities. To conform to the T+1 Adopting Release, this period could be set at 24 hours or one business day. This would allow RIAs to trade and settle transactions on behalf of clients in both crypto and traditional assets with limited exposure to any risks the Commission may be concerned about while realizing the benefits of shorter settlement periods it has previously acknowledged.

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[44] *See* 17 CFR § 240.15c3-3(c)(6)(i); FINRA, *SEA Rule 15c3-3 and Related Interpretations* (accessed Mar. 28, 2023), available at https://www.finra.org/rules-guidance/guidance/interpretations-financial-operational-rules/sea-rule-15c3-3-and-related-interpretations (interpreting securities in transit for five business days or less between the broker-dealer and control locations to be under broker-dealer control); SEC, *Interpretive Releases Relating to the Securities Exchange Act of 1934 and General Rules and Regulations Thereunder*, Exchange Act Rel. No. 9922, 38 FR 1737 (Jan. 18, 1973).

[45] *See generally* 30 CFR Ch. X; *see also* 30 CFR § 1010.100(t) (defining which financial institutions are subject to anti-money laundering program requirements).

[46] For the purposes of the letter, we use the phrase "transfer message" to refer to messages like those used by the Society for Worldwide Interbank Financial Telecommunication ("SWIFT").

F. The Commission should allow standards of care, indemnification, and insurance requirements to be tailored by asset class.

The Commission should modify the Proposal to interpret "adequate insurance" as insurance arrangements that are reasonably available to qualified custodians by asset class (*i.e.*, securities, derivatives, crypto) and clarify such insurance need not fully indemnify clients. The Commission should also allow custodial standards of care to be tailored by asset class and consider requiring RIAs or custodians to disclose the custodial risks associated with different asset classes. This would appropriately balance investor protection with competition and cost to RIA clients. These changes would ensure qualified custodians are not forced to exit custodial markets because they cannot obtain insurance satisfying Commission expectations and also would not put RIA's in a position of guessing when insurance is "adequate."

Proposed Rule 223-1 would require RIAs to obtain written assurances from qualified custodians that the custodians would comply with certain requirements. These requirements include that qualified custodians would obtain insurance arrangements to adequately protect RIA clients from losses caused by the custodian.[47] It is currently uncommon for custodians to indemnify their clients. Rather, the custodian, as the client's agent, is typically indemnified by the client for following the client's instructions and otherwise performing under the custody agreement while remaining liable to the client for breaches of the applicable standard of care. This arrangement directly affects the pricing terms the custodian is able to offer the client. A greater indemnification requirement and less forgiving standard of care necessarily increases custodian costs, including for insurance and reserves against loss. These costs then translate into higher fees for RIA clients.

While the Proposal is unclear about the scope of losses the Commission expects to be indemnified, implementing a full risk of loss indemnification requirement would materially change the economics of custodial relationships, as the Commission recognizes,[48] particularly for alternative assets like crypto assets. This would dramatically increase the potential liability to custodians holding RIA client assets and the costs of protecting against such liability. This would, again, directly translate into higher costs for custodial clients, thereby limiting their ability to make investments. Therefore, the Commission should make clear that the Proposal would not require full indemnification.

The Proposal's "adequate insurance" requirement raises similar concerns. Crucially, the Proposal does not define what sorts of insurance arrangements would be adequate. As a result, the Proposal would create interpretive ambiguity and confusion as to whether a given insurance arrangement was "adequate." The Commission should make clear what adequate insurance is and adopt a definition that only requires custodians to obtain insurance that is reasonably available for a given asset class. For example, Coinbase's exchange and Coinbase Custody have sought and obtained the maximum available insurance to protect client assets on-platform. This maximum is determined by what insurance providers are willing to offer. However, much like FDIC insurance, in some cases this insurance would not protect clients against full risk of loss. Therefore, if the Commission's expectation is that qualified custodians obtain insurance to indemnify RIA clients against the full risk of loss, it would effectively ban qualified custodians like Coinbase Custody from serving RIA clients.

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[47] Proposed Rule 223-1(a)(1)(ii)(B).

[48] *See* Proposal at 14694 ("the proposed indemnification requirement would likely operate as a substantial expansion in the protections provided by qualified custodians to advisory clients, in particular because it would result in some custodians holding advisory client assets subject to a simple negligence standard rather than a gross negligence standard").

Proposed Rule 223-1 would also require RIAs to obtain written assurances from qualified custodians that they would indemnify RIA clients for losses caused by custodian negligence, recklessness, or willful misconduct.[49] Negligence, recklessness, and willfulness exist on a spectrum and the word "or" is disjunctive. Thus, the Proposal would set the custodial standard for all RIA client assets to negligence, the standard that poses the highest potential liability to custodians of the three listed standards. Under a negligence standard, one may be held liable for failing to exercise "due care" as determined by a court, jury, or other tribunal, regardless of how seriously one takes their duties. In contrast, other standards, such as gross negligence, require one to disregard their duties to be liable. This distinction is critical for traditional and alternative asset custodians when it is difficult to predict what a court, jury, or other tribunal would view as "due care." In the Proposal, the Commission recognized "that the appropriateness of the measures required to safeguard assets varies depending on the asset."[50] This should include the standards of care applicable to custodial relationships.

To see why, note that some securities custodians enter custodial arrangements under a negligence standard because the chain of custody for most traditional securities is well established. This follows from the fact that the vast majority of securities are held in a layered chain of custody from a global custodian to sub-custodian (if applicable) to CSD or transfer agent. In such arrangements, beneficial ownership is transferred by changes to a custodians' books, but the CSD or transfer agent ultimately holds the securities and custodians are confident the risk of loss from these parties is small. Moreover, because these custodial arrangements have developed over the course of decades, securities custodians are more likely to be able to predict how a court, jury, or other tribunal would interpret "due care" with respect to their custodial services, and appropriately price the indemnification risks under a negligence standard.

In contrast, custodians specializing in non-securities, such as Coinbase Custody, generally enter custodial arrangements under a standard that reflects the legal uncertainties surrounding the custody of alternative assets. Coinbase Custody exercises what it believes to be due care with respect to unique operational complexities of crypto assets. These include controls to account for atomic settlement,[51] transaction irreversibility, lack of regulatory clarity, and the absence of widely accepted industry practices.[52] However, the novelty of these factors make it virtually impossible to know what a court, jury, or other tribunal would view as due care for crypto asset custody. This lack of clarity, in turn, makes it difficult to determine when losses should be attributed to crypto asset custodians, *i.e.*, because they failed to exercise due care, or are the result of factors beyond the custodians' control. This means in the event of a dispute, a court, jury, or other tribunal would have to make an *ad hoc* and unpredictable decision as to whether losses should be attributed to a custodian. The uncertainty created by such decisions, or even the potential for such decisions, leaves custodians with two choices: substantially raise prices or exit the market. Neither would help investors, promote efficient markets, or facilitate capital formation.

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[49] Proposed Rule 223-1(a)(1)(ii)(B).

[50] Proposal at 14693.

[51] "Atomic settlement" generally refers to settlement that is both instantaneous and simultaneous. *See* Michael Lee, Antoine Martin, and Benjamin Müller, *What Is Atomic Settlement?*, Fed. Reserve Bank of NY: Liberty St. Econ. (Nov. 7, 2022), *available at* https://libertystreeteconomics.newyorkfed.org/2022/11/what-is-atomic-settlement/.

[52] *Accord* Proposal at 14694 ("because crypto assets and distributed ledger technology are still evolving, we expect the methods used to safeguard crypto assets will likewise evolve, which may lead to reevaluation of best practices in the future").

To ensure custodians are able to appropriately price their services and account for the realities of the insurance market, the Commission should revise the Proposal to allow standards of care to be tailored by asset class. To effect this change, the Commission should revise Proposed Rule 223-1(a)(1)(ii)(B) to read:

> *The qualified custodian will indemnify the client* ***in accordance with commercial norms*** *(and will have insurance arrangements in place that will adequately protect the client) against the risk of loss of the client's assets maintained with the qualified custodian in the event of the qualified custodian's own negligence,* ***gross negligence,*** *recklessness, or willful misconduct****, as applicable****;*

The reference to commercial norms is intended to accomplish the Commission's stated goal of promoting a universal standard of care, but doing so by asset class.[53] Thus, securities custodial arrangements could be entered under a negligence standard if that is the commercial norm for such arrangements. However, custodial arrangements for alternative assets would be entered under the standard of care that is the commercial norm for those assets. For crypto assets, we expect this to be gross negligence. Further, this change would align with the Commission's goal of ensuring the Proposal "remain[s] evergreen, encompassing new investment types as they continue to evolve" because as commercial norms mature for a particular asset class, the standard of care could be adapted to those new norms.[54] For example, the commercial norm for crypto assets is likely to be gross negligence. However, with technological advances or additional legal clarity, this may be revised to negligence in the future. Were negligence to become the commercial norm, the Proposed Rule would prohibit market entrants from using an alternative standard, without any additional Commission rulemaking or guidance. Moreover, as standards of care will likely differ by asset class, the Commission should consider adding a requirement that RIAs or custodians disclose custodial risks associated with different asset classes.

The Proposal should also account for the realities of the custodial insurance market by clarifying that "adequate insurance" refers to insurance that is reasonably available for a particular asset class. The Commission has taken this approach in other recent rules and proposals. For example, Regulation Best Interest,[55] which requires broker-dealers making recommendations to retail customers to act in the retail customers' best interest, only requires broker-dealers to consider "reasonably available alternatives" to form the basis for their recommendations.[56] Similarly, proposed Regulation Best Execution,[57] which would require broker-dealers to use reasonable diligence to ascertain and execute customer security transactions in the best market, would only require broker-dealers to obtain and assess "reasonably accessible information" to determine the best market.[58] In the Regulation Best Execution proposal, the Commission specifically recognized unreasonably high fees would preclude information from

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[53] *See id.* at 14694 ("the standard of care is not universal in the custodial market, and that this requirement may result in some qualified custodians changing the terms of their custodial agreements with advisory clients to incorporate this standard. We believe that this provision would promote this important protection in a consistent manner across all advisory client assets and would discourage the qualified custodian from establishing contractual performance standards that are less stringent").

[54] Proposal at 14678-14679.

[55] 17 CFR § 240.15*l*-1.

[56] SEC, *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, Exchange Act Rel. No. 86031, 84 FR 33318, at 33380 (Jul. 12, 2019).

[57] *See* Proposed 17 CFR § 242.1100.

[58] *See* Proposed 17 CFR § 242.1101(a).

being reasonably accessible.[59] The Commission should adopt a similar approach for the safeguarding rule by clarifying that to satisfy the adequacy standard, qualified custodians need only obtain insurance that is reasonably available, considering cost and the coverage insurers are willing to provide.

G. The Commission should allow sophisticated investors to negotiate their own custodial arrangements.

The Commission should revise the Proposal to clarify that the reasonable assurances, including those for standards of care and insurance arrangements, only apply to RIA clients that are not in a position to negotiate the terms of their custodial agreements. The Proposal does not distinguish between different types of RIA clients. Thus, RIAs serving highly sophisticated institutional investors must ensure their clients enter custody arrangements on substantially the same terms as those serving retail investors. As a result, the Proposal would remove the ability of sophisticated investors to negotiate the terms of their custodial contracts. However, these types of investors are in a better position than the Commission to weigh the costs and benefits of different custodial arrangements, and negotiate appropriate terms. Therefore, the Commission should revise the Proposal to ensure they are able to do so.

By statute and rule, Congress and the Commission have consistently recognized different types of investors require different levels of regulatory oversight. For example, the Investment Company Act does not require funds owned by "qualified purchasers" to register with the Commission,[60] and the Securities Act does not require securities offerings made exclusively to "accredited investors" to be registered with the Commission.[61] The Commission should take the same approach to RIA clients by continuing to allow sophisticated RIA clients such as high net worth individuals and institutions to negotiate their own custodial arrangements. These investors are better positioned than the Commission to balance the risks of custodying different asset classes at different types of custodians against the costs resulting from different standards of care, levels of indemnification, and insurance arrangements. Therefore, the Commission should revise the Proposal to ensure the reasonable assurances, including those for standards of care and insurance arrangements, only apply to RIA clients that are not in a position to negotiate the terms of their custodial agreements.

H. The Commission should revise the Proposal to allow RIA custody in additional circumstances.

The Commission should expand the exception allowing RIAs to custody physical assets and certain private securities to include any asset the RIA reasonably determines is unable to be maintained at a qualified custodian. Like the current Custody Rule, Proposed Rule 223-1 requires RIAs to hold client assets at a qualified custodian subject to limited exceptions. Proposed Rule 223-1 narrows these exceptions to only physical assets and a limited set of private securities. By limiting the qualified custodian exception to physical assets and certain private securities while expanding the scope of the rule to all client assets (rather than just funds and securities), the Commission would effectively ban RIAs from investing client assets in asset classes that cannot be held at a qualified custodian, including early stage crypto tokens. This

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[59] SEC, *Regulation Best Execution*, Exchange Act Rel. No. 96496, 88 FR 5440, at 5457 (Jan. 27, 2023).

[60] Investment Company Act § 3(c)(7) (15 USC § 80a-3(c)(7)) (exempting funds owned exclusively by qualified purchasers from registering with the Commission); Investment Company Act § 2(a)(51) (15 USC § 80a-2(a)(51)) (defining "qualified purchaser").

[61] Securities Act § 4(a)(2) (15 USC § 77d(a)(2)) (exempting private offerings from Commission registration); 17 CFR § 230.506(c) (exempting security offerings made exclusively to accredited investors from Commission registration).

ban, unaccounted for in the Commission's cost-benefit analysis, is clearly beyond the intent of the Advisers Act, as amended by Dodd-Frank, which does not mention banning RIAs from investing in particular asset classes. Moreover, the narrow exceptions in the Proposal do not account for the benefits of blockchain technology or crypto asset market practices. These include the ability to avoid the use and risks of costly intermediaries and protect client assets by holding them in off-platform cold storage verifiable through blockchains until an RIA intends to execute a trade. The Proposal would prohibit these practices without any attendant benefits to RIA clients. The Commission could avoid these issues by expanding the qualified custodian exception to include any asset the RIA reasonably determines is unable to be maintained at a qualified custodian.

To issue the Proposal, the Commission relied on a provision of the Advisers Act added in 2010 as part of the Dodd-Frank Act ("**Safeguarding Provision**").[62] The Safeguarding Provision in total provides

> *An investment adviser registered under this subchapter shall take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the Commission may, by rule, prescribe.*

The Safeguarding Provision contains no language banning RIAs from investing client assets in any particular asset class or authorizing the Commission to do so, directly or indirectly. However, by expanding qualified custodian requirements to any RIA client asset, without a meaningful exception for assets that cannot be held with a qualified custodian, the Proposal does just that. This result contradicts Congressional intent and exceeds the authority provided to the Commission in the Safeguarding Provision.

Moreover, current custody rules assume an intermediated custody model where RIA clients hold their assets at a third-party custodian, often a bank or broker-dealer. To execute transactions, RIAs with discretionary authority direct these custodians to use other intermediaries such as exchanges, market makers, transfer agents, and clearing agencies. All these intermediaries charge fees for their services that are passed on to RIA clients. One of the many benefits of blockchain technology is the ability to remove many of these intermediaries by enabling asset holders to self-custody assets and execute transactions directly on centralized exchanges like Coinbase or through decentralized applications. Eliminating unnecessary layers of intermediation promises to improve consumer experience, lower costs, and reduce the risks of intermediation (including bankruptcy risk). Moreover, even when intermediaries are used in crypto, including RIAs, it is much harder for them to misappropriate client assets because those assets are always reconcilable to the blockchain.

To achieve the benefits of disintermediation, RIAs often hold non-security crypto assets on behalf of their clients using self-custodial wallets. They do this to add an additional layer of protection against cybersecurity risks. Holding crypto assets as a custodian ordinarily involves holding cryptographic keys associated with blockchain addresses where the assets are stored. As a best practice, many crypto asset custodians split access to such keys to mitigate the risk of loss or theft between separate physical or digital locations. When an RIA holds client crypto assets at a third-party custodian, it can create a single point of failure increasing the risk of theft if that custodian does not have appropriate controls in place. Therefore, many RIAs hold client

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[62] *See* Advisers Act § 223 (codified at 15 USC § 80b-18b); Dodd-Frank Wall Street Reform and Consumer Protection Act § 411, Pub. L. 111-203, 124 Stat. 1577 (Jul. 21, 2010).

crypto assets, usually in cold storage, and only transfer such assets to third party exchanges at the time of a transaction. This strategy has been effective at protecting RIA clients from theft and misappropriation.[63]

There are also a limited number of qualified custodians available to custody crypto assets and these few will often not hold early-stage crypto assets. This occurs because qualified custodians like Coinbase Custody test and review new assets against their exacting security and engineering standards before they will hold any particular crypto asset, which can often involve a lengthy process of integrating the asset into an extensive suite of products. This process takes time and resources and crypto custodians often have to make business decisions about which new assets to review and test and which ones not to. Early-stage crypto assets often have not had sufficient time to be tested and reviewed and therefore cannot be held at a qualified custodian. To solve this problem, there is a cottage industry of specialty firms that help RIAs and other crypto asset market participants retrofit or build facilities to hold early-stage crypto assets.

Given that early-stage tokens generally cannot be held at qualified custodians, and the limited risks and heightened benefits of RIAs holding them, the Commission should broaden the exception in Proposed Rule 223-1(b)(2) to allow crypto assets that cannot be held at a qualified custodian to be held by the RIA. Proposed Rule 223-1(b)(2) would allow RIAs to hold certain privately offered securities or physical assets that are unable to be maintained at a qualified custodian, provided certain conditions are met. These include the RIA determining "ownership cannot be recorded and maintained (book-entry, digital, or otherwise) in a manner in which a qualified custodian can maintain possession or control of such assets." To allow RIA clients to take advantage of the benefits of blockchain technology, the Commission should revise Proposed Rule 223-1(b)(2) to allow RIAs to hold any client assets that are unable to be maintained at a qualified custodian and modify the RIA justification requirement to remove references to how ownership is recorded. This would limit the RIAs' written determination to qualify for the exception to why the assets cannot be held at a qualified custodian. Doing so would ensure client assets that cannot be held at a qualified custodian are appropriately safeguarded.

I. The Commission should adopt a unified possession or control standard to allow consumers to hold crypto assets at a broader range of qualified custodians.

Coinbase applauds the Commission's acknowledgement that qualified custodians may hold crypto assets subject to requirements matching the underlying technology. The Commission should clarify this interpretation applies to broker-dealers by rescinding staff guidance requiring them to demonstrate *exclusive* possession or control to custody crypto assets. As noted above, Proposed Rule 223-1 requires qualified custodians to maintain possession or control of RIA client assets. The Proposal's definition of possession or control turns on whether the qualified custodian is required to participate in a change in beneficial ownership of a particular asset. In the Proposal, the Commission clarified that qualified custodians are not required to demonstrate "exclusive" possession or control of crypto assets to comply with the Proposal.[64] Rather, they may demonstrate possession or control by generating and maintaining private keys so that RIAs are unable to change beneficial ownership without qualified custodian involvement.

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[63] Consider, for example, RIAs who implemented this strategy for FTX.

[64] *See* Proposal at 14689 ("While demonstrating that a qualified custodian has exclusive possession or control of an asset would be one way to demonstrate that the qualified custodian is required to participate [*sic*] a change of beneficial ownership, it is not the only way").

The Commission should extend this interpretation to its other registrants, most notably broker-dealers. While broker-dealers are qualified custodians under the current Custody Rule and Proposal,[65] they are subject to separate possession or control requirements under the Customer Protection Rule.[66] In 2019, Commission staff issued a joint statement with FINRA explaining how the Customer Protection Rule applies to "digital asset securities."[67] Critically, the staff stated

> *the fact that a broker-dealer (or its third party custodian) maintains the private key may not be sufficient evidence by itself that the broker-dealer has exclusive control of the digital asset security (e.g., it may not be able to demonstrate that no other party has a copy of the private key and could transfer the digital asset security without the broker-dealer's consent).*

This statement introduced a new custody standard for broker-dealers by requiring them to demonstrate "exclusive control" of digital asset securities, even though the exclusivity concept is not mentioned in the Customer Protection Rule and is not required for traditional assets.[68] The Joint Statement was widely read by industry participants to mean registered broker-dealers would need to demonstrate exclusive possession or control to hold any crypto assets (securities or otherwise) or face a Commission enforcement action. To demonstrate exclusive possession or control, a custodian must first demonstrate it has possession or control and then demonstrate that no one else does. However, it is not possible to demonstrate the second prong, even for traditional assets, because it requires proving a negative. Thus, the exclusivity standard effectively prohibits broker-dealers from holding crypto assets. It also subjects broker-dealers to a higher custodial standard for crypto assets than other types of qualified custodian such as banks and foreign financial institutions that do not need to demonstrate exclusive control.

The Commission should adopt a technology and entity neutral stance towards crypto assets by allowing broker-dealers to custody these assets under a similar possession or control standard as the Proposal. Allowing broker-dealers to hold crypto assets at other qualified custodians would not constitute "exclusive" control, but it should be permissible in achieving the Commission's policy and customer protection goals if possession or control is able to be established using the definition from the Proposal.

For example, Coinbase has developed industry-leading crypto asset custody practices and Coinbase Custody operates as a state-supervised trust company exercising national bank style fiduciary powers. The Customer Protection Rule deems securities to be under the control of a broker-dealer when they are in the custody or control of a "bank" as defined in the Exchange Act and are not subject to any lien or claim in favor of the bank or any person claiming through the

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[65] *See* Proposed Rule 223-1(d)(10)(ii); 17 CFR § 275.206(4)-2(d)(6)(ii).

[66] 17 CFR § 240.15c3-3 (requiring broker-dealers to "promptly obtain and shall thereafter maintain the physical possession or control of all [customer] fully-paid securities and excess margin securities" but not *exclusive* possession or control).

[67] *See* SEC & FINRA, *Joint Staff Statement on Broker-Dealer Custody of Digital Asset Securities* (Jul. 8, 2019) ("Joint Statement"), available at https://www.sec.gov/news/public-statement/joint-staff-statement-broker-dealer-custody-digital-asset-securities.

[68] The Commission later added "exclusive control" in its no action position relating to broker-dealers dealing in digital asset securities. *See Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Exchange Act Rel. No. 90788, 86 FR 11627, 11631 (Feb. 26, 2021) (providing no action relief to broker-dealers dealing in digital assets provided nine conditions are met, including that a broker-dealer "establishes, maintains, and enforces reasonably designed written policies, procedures, and controls that are consistent with industry best practices to demonstrate the broker-dealer has *exclusive control* over the digital asset securities") (emphasis added).

bank.[69] The Exchange Act defines "bank" in substantially the same manner as the Advisers Act, that is, to include state-chartered trust companies.[70] Therefore, just as Coinbase Custody is a qualified custodian, it should be able to serve as a good control location for broker-dealers. The rules are clear that broker-dealers may custody crypto-assets using state trust companies as a good control location. It is only the staff guidance in the Joint Statement and the threat of enforcement action that makes this unclear.

The Commission should be comfortable rescinding the Joint Statement and related staff guidance[71] because there is nothing fundamentally different about crypto asset custody (securities or otherwise) than traditional assets with respect to the concerns highlighted in the Joint Statement. In the Joint Statement, the staff contrasted blockchains with traditional architecture where broker-dealers are able to reverse or cancel mistaken or unauthorized transactions. The staff reasoned that the inability to reverse or cancel transactions could "cause securities customers to suffer losses, with corresponding liabilities for the broker-dealer, imperiling the firm, its customers, and other creditors." However, when customers of centralized exchanges like Coinbase mistakenly send assets to another centralized exchange, bank, broker-dealer, or other corporate entity, Coinbase can, just like broker-dealers currently do, contact those entities and ask to reverse those transactions. Similarly, when customers take their assets outside of a centralized corporate environment, just like broker-dealers or banks when a customer withdraws cash in physical form, executes a peer-to-peer transfer (*e.g.*, Zelle, Cash App, or Venmo), or transfers assets outside the United States, Coinbase is limited in its ability to to reverse those transactions.

Furthermore, to enable crypto asset trading, broker-dealers must be able to send customer assets to a crypto exchange. Broker-dealers and other qualified custodians should be able to facilitate customer trading by transferring assets to exchanges at the time of settlement. Since crypto exchanges like Coinbase are regulated under state banking laws requiring similar customer protections as the Customer Protection Rule, and crypto asset transactions are generally settled instantaneously, this would not introduce any risk to customer assets.[72]

For these reasons, the Commission should clarify that broker-dealers do not need to establish exclusive possession or control. Rather, the Commission should adopt the possession or control standard from the Proposal across its registrants. This uniformity would allow any Commission registrant to demonstrate possession or control of crypto assets if it generates and maintains private keys for wallets holding client or customer crypto assets in a manner such that beneficial ownership of crypto assets cannot be changed without the custodian's involvement.

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[69] 17 CFR § 240.15c3-3(c)(5).

[70] 15 USC § 78c(a)(6) (Exchange Act defining "bank" to mean, among other things, any "banking institution … doing business under the laws of any State … a substantial portion of the business of which consists of … exercising fiduciary powers similar to those permitted to national banks …, and which is supervised and examined …, and which is not operated for the purpose of evading the provisions of this chapter"); *Accord* 15 USC § 80b-2(a)(2) (Advisers Act defining "bank" to mean any "banking institution, … or trust company, … doing business under the laws of any State …, a substantial portion of the business of which consists of … exercising fiduciary powers similar to those permitted to national banks …, and which is supervised and examined …, and which is not operated for the purpose of evading the provisions of this subchapter"). NY state-chartered trust companies like Coinbase Custody are state supervised banking institutions whose business consists exclusively of exercising fiduciary powers similar to those permitted to national banks.

[71] *See e.g.*, SEC No Action Letter to FINRA, *ATS Role in the Settlement of Digital Asset Security Trades* (Sep. 25, 2020) available at https://www.sec.gov/divisions/marketreg/mr-noaction/2020/finra-ats-role-in-settlement-of-digital-asset-security-trades-09252020.pdf; SEC, *Custody of Digital Asset Securities by Special Purpose Broker-Dealers*, Exchange Act Rel. No. 90788, 86 FR 11627 (Feb. 26, 2021).

[72] *See* 23 CRR-NY §§ 200.8, 200.9, 200.12 (subjecting N.Y.-licensed virtual currency businesses to capital requirements, custody, and books and records requirements).

J. The Commission should modify the Proposal's external reconciliation requirements to allow qualified custodians to use the best available data.

The Commission should modify the Proposal to exempt assets not held in layered custodial relationships (*i.e.*, most assets other than funds or securities) from the external reconciliation requirement or clarify that external reconciliation may be conducted using the best available data sources, even if those sources are not qualified custodians. Proposed Rule 223-1 would require RIAs to hold client assets at a qualified custodian pursuant to a written agreement that, among other things, would require custodians to obtain internal control reports from an independent public accountant ("**IPA**").[73] Like the current rule,[74] when a qualified custodian is affiliated with the RIA, the Proposal would require the IPA to verify client assets are reconciled to a custodian other than the RIA or its affiliate.[75] With respect to the current rule, the Commission stated "tests of the custodian's reconciliation(s) should include either direct confirmation, on a test basis, with unaffiliated custodians or … verify that the data used in reconciliations performed by the qualified custodian is obtained from unaffiliated custodians[.]"[76]

The current rule only applies to "funds and securities" while the Proposal would apply to all client assets. This distinction is crucial as funds and securities are generally held in layered custodial arrangements such as the Federal Reserve System or the Depository Trust Company, while most other assets are not. Thus, imposing the external reconciliation requirement from the current rule on alternative assets would preclude RIAs from holding many alternative assets at affiliated custodians. For example, crypto assets are natively issued by a blockchain. Most blockchains are decentralized entities with no central group of persons in charge. These blockchains would likely not be considered "custodians" and thus could not be sources of external reconciliation data under the Proposal. However, since it is the blockchains that ultimately determine who controls a crypto asset, the Commission would be banning the use of the most reliable data sources to reconcile crypto assets. Many other asset classes have similar issues, including many commodities and uncleared derivatives.

Banning RIAs from holding assets other than funds and securities at affiliated custodians would be a radical departure from current industry practice. Moreover, the Commission should tailor its rules by asset class to allow the use of the most reliable sources of data to reconcile holdings of client assets. Therefore, the Commission should either exempt assets, including crypto assets, not held in layered custodial arrangements from the external reconciliation requirement, or clarify that external reconciliation may be conducted using the best available data sources, such as blockchains for crypto assets.

K. The Commission should direct the staff to revise its accounting guidance to account for the Proposal's enhanced custody protections.

The Commission should direct the staff to modify Staff Accounting Bulletin No. 121 ("**SAB 121**") to exempt qualified custodians from its accounting requirements. As discussed in more detail below, the interaction between SAB 121 and the Proposal should allow traditional financial

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[73] Proposed Rule 223-1(a)(1)(i)(C).

[74] 17 CFR § 275.206(4)-22(a)(6)(ii)(B).

[75] Proposed Rule 223-1(a)(1)(i)(C)(1).

[76] SEC, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, Advisers Act Rel. No. 2969 (Dec. 30, 2009), available at https://www.sec.gov/rules/interp/2009/ia-2969.pdf.

institutions to custody crypto assets. The staff's stated goal in SAB 121 was to mitigate legal uncertainty surrounding crypto assets, including bankruptcy treatment. The Proposal obviates that goal for qualified custodians by requiring them to hold RIA client assets in bankruptcy remote accounts. Therefore, the Commission should modify SAB 121 to account for these changes, thereby allowing public companies, including banks, to hold crypto assets without recording those assets on their balance sheets.

On March 24, 2022, the staff issued SAB 121, which generally requires public companies safeguarding crypto assets to record those assets as liabilities on their balance sheets.[77] The staff stated crypto safeguarding arrangements "involve unique risks and uncertainties not present in arrangements to safeguard [traditional assets], including" technological risks, legal risks due to a lack of precedent (especially how crypto assets would be treated in bankruptcy), and regulatory risks arising from the fact that fewer regulatory requirements apply to crypto assets.[78] To mitigate these risks, SAB 121 requires, among other things, that public companies safeguarding crypto assets recognize those assets on their balance sheets. This requirement effectively prohibits many public financial institutions from safeguarding crypto assets by triggering capital adequacy requirements that are prohibitively expensive.

To see why, note that without SAB 121 banks could hold crypto assets pursuant to a bailment or trust[79] recorded as off-balance sheet items. However, banks and bank holding companies ("**BHCs**") that are public companies must comply with SAB 121, meaning that even under a bailment or trust with no credit risk, they must record crypto assets on-balance sheet. This on-balance sheet accounting treatment then interacts with capital rules requiring banks / BHCs to hold prescribed amounts of tier 1 capital. Under current capital rules, crypto assets are deducted from bank / BHC tier 1 capital as intangible assets.[80] To satisfy their tier 1 capital requirements, banks / BHCs holding crypto assets must raise additional tier 1 capital to cover the deduction. Tier 1 qualifying assets often generate returns that are near or below inflation.[81] To be profitable, banks / BHCs must achieve returns significantly above inflation. Thus by requiring banks / BHCs to raise additional tier 1 capital, SAB 121 directly reduces their profitability. This effect is proportional to the amount of crypto assets a bank or BHC holds such that the more crypto assets they hold, the less profitable they become. In this way, SAB 121 makes it non-economical for banks and BHCs to custody crypto assets.

In the absence of Commission rulemaking related to crypto asset custody, it was reasonable for the staff to address gaps by issuing SAB 121. For example, without Commission action, RIA clients may not know whether a firm safeguarding their crypto assets holds them as a bailee or

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[77] SEC, *Staff Accounting Bulletin No. 121* (Mar. 24, 2022), *available at* https://www.sec.gov/oca/staff-accounting-bulletin-121.

[78] For example, because crypto assets are not subject to the federal securities laws.

[79] Bailment and trust relationships involve holding an asset on another's behalf similar to a safe deposit box. This is in contrast to bank depositor relationships, which generally create debtor-creditor relationships. Assets held in bailments or trusts are generally bankruptcy-remote because title to the underlying assets does not transfer to the bailee or trustee.

[80] *See e.g.,* 12 CFR Pt. 225, App. A § II.B.i.b. The Basel Committee on Bank Supervision has recommended a 1250% risk-weight (equivalent to a capital deduction) for illiquid crypto-assets, a market risk capital charge for liquid crypto assets, and a standard capital charge for tokenized securities and stablecoins. Bank for International Settlements, *Basel Committee on Bank Supervision: Prudential treatment of cryptoasset exposures* (Dec. 2022), *available at* https://www.bis.org/bcbs/publ/d545.pdf.

[81] For example, U.S. Treasuries, generally treated as risk-free assets, are tier 1 assets that currently provide an approximate 3.7% return, while inflation as measured by the Consumer Price Index ("CPI") is currently 6%. *See* U.S. Treasury Department, *Daily Treasury Long-Term Rates* (accessed Mar. 27, 2022), available at https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics; U.S. Bureau of Labor Statistics, *Consumer Price Index* (accessed Mar. 27, 2022), available at https://www.bls.gov/cpi/. This means someone holding U.S. Treasuries achieves a real rate of return of approximately negative 2.3%.

trustee (with no credit risk) or as a debtor (with credit risk). Therefore, requiring safeguarding firms to record crypto assets on their balance sheets with a corresponding liability could make sense from a consumer protection standpoint. However, the Proposal changes this conclusion for qualified custodians. As noted above, the Proposal requires banks holding RIA client assets, including crypto assets, to do so in an "account designed to protect such assets from creditors of the bank or savings association in the event of the insolvency or failure of the bank," that is, as a bailee or trustee.[82] The Commission noted this provision was to bring bank custody practices in-line with those of broker-dealers, which generally hold customer assets as bailees.[83] Thus, if adopted, the Proposal would obviate the concerns behind SAB 121 for qualified custodians.

Because the Proposal would address the staff's concerns in SAB 121, the Commission should direct the staff to modify SAB 121 to exempt assets held by qualified custodians. This would allow greater access to crypto assets in a broader swath of well-regulated institutions that would hold those assets in a manner consistent with consumer protection concerns.

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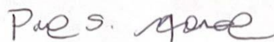
Coinbase applauds the Commission's use of APA notice and comment rulemaking. Our markets prosper when the Commission undertakes a thoughtful approach to regulation. While the Proposal contains a number of best practices, Coinbase has concerns about specific aspects, as described above. If these concerns are addressed, we would support the Proposal. In the meantime, we welcome the opportunity to continue discussing how the Commission can best fulfill its mandate with respect to the crypto asset market.

Sincerely,



Paul Grewal
Chief Legal Officer
Coinbase Global, Inc.

cc: The Hon. Gary Gensler, Chair
The Hon. Hester M. Pierce, Commissioner
The Hon. Caroline A. Crenshaw, Commissioner
The Hon. Mark T. Uyeda, Commissioner
The Hon. Jaime E. Lizárraga, Commissioner

[82] Proposed Rule 223-1(d)(10).

[83] *See* Proposal at 14683.