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

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

May 8, 2023

Dear Ms. Countryman,

We submit this letter in response to the request for public input on the U.S. Securities and Exchange Commission's proposed amendments ("Proposed Rule") to Rule 206(4)-2 under the Advisers Act ("Custody Rule"). Thank you for the opportunity to provide comments on this proposed rule.

Americans for Financial Reform Education Fund (AFREF) is a nonpartisan, nonprofit coalition of more than two hundred civil rights, community-based, consumer, labor, small business, investor, faith-based, civic groups, and individual experts. We fight for a fair and just financial system that contributes to shared prosperity for all families and communities.

Demand Progress Education Fund (DPEF) works to elevate regulators who care more about the wellbeing of everyday people than Wall Street's bottom line, and fights to ensure that Congress conducts oversight to hold the financial sector accountable. We oppose deregulation and consolidation that makes our financial system less sound and push back against attempts by the finance and tech sectors to normalize exploitative products and systems.

We write to express support for the agency's proposed amendments. While the proposed updates to the rule apply to and will impact custodial practices and requirements for registered investment advisers in a range of different circumstances and regarding a wide range of assets, our focus here is on the important fact that the new rules will address significant and longstanding problems associated with the custody of crypto assets.

To that end our comments largely focus on the following question posed by the agency in its request for comment,

> "281. The proposed rule would expand the scope of assets currently subject to the custody rule. To what extent do investors benefit from advisers having custody of assets newly scoped in under the proposed rule? What is the nature of those benefits? To what extent would those benefits be lost given the requirements of the proposed rule?"

We generally believe the new rule would be effective in ensuring those investors working with registered investment advisers can be confident that their assets are being maintained safely and securely at a level on par with existing practices in traditional finance. Such security is greatly needed given that the crypto industry has a poor track record with regard to custody of assets. Additionally, custody is a bedrock issue for any investment activities executed in financial markets; without it, other safeguards and best practices cannot be assured. Finally, a new rule, implemented in a timely fashion, would offer a tough

but fair standard that would raise the standard of practice and compel crypto platforms to either offer greater safety and security to their clients or exit the market if they are unable to do so.

1. **The crypto industry has a poor track record when it comes to ensuring investor assets are secure and well protected from loss, theft or misappropriation** – The recent and ongoing crash of crypto markets has laid bare widespread problems with respect to custody of crypto investors' assets. The most notable examples are already found in the staff comments with respect to this new rule; FTX's failure and/or willful misappropriation of the assets it custodied for its clients, and the travails of Celsius' investors who may lose their assets in bankruptcy proceedings because Celsius' terms of use failed to provide for segregation of those assets in the event of insolvency. But, these examples, while egregious and significant in scale, are by no means the only example of custody failures within the crypto industry. We share a few examples below to help illustrate how commonplace these failures have been throughout the sector:

- **Vulcan Forged Wallet Hack:** In December 2021, a hacker stole crypto valued at $140 million from Vulcan Forged, a crypto gaming ecosystem that includes its own decentralized crypto exchange, wherein users trade its native token, PYR. Upon registering their accounts, Vulcan Forged customers were given a set of wallets on various blockchains (Ethereum, Polygon and VeChain) that allowed them to use tokens on the platform, which the platform managed for them. The wallets themselves were created by a third party, Venly. The hacker was able to steal 96 private keys (corresponding with a similar number of wallets) from the platform. The theft (which amounted to 4.5 million PYR) was equivalent to 9% of the project's total token supply, and 23.7% of all PYR tokens in circulation. Vulcan Forged drew from its Treasury to reimburse customers. At the time of the exploit, about half the funds had been reimbursed to customers. However, news of the event resulted in a 22% decrease in the price of PYR, and the platform announced it was removing its custodial services from the platform and directing customers to find their own custodial solutions from there on out.[1]

- **Crypto.com Wallet Hack:** In January 2022, Singapore-based Crypto.com, a major crypto exchange, experienced a security breach that led to the theft of ETH and BTC, with values at the time approaching as much as $33 million, according to both the platform and industry analysts. The assets were taken from custodial wallets Crypto.com hosted for its customers. The stolen ETH was moved through Tornado, a platform that 'mixes' crypto transactions, making them more difficult to track. At the time of the hack, crypto.com customers were reporting their losses online, and analysis suggested that the hackers were able to bypass or override the two-factor authentication protocols set up to prevent unauthorized transactions associated with their hosted wallets. After initially communicating to platforms users their funds were safe, Crypto.com at the time temporarily suspended withdrawals on the platform.[2]

- **Voyager Bankruptcy** – The collapse of Voyager Digital in 2022 provides textbook examples of why the custody rule changes proposed here are valuable. As is now clearly understood, Voyager

[1] https://www.theblock.co/post/127270/96-private-keys-stolen-from-vulcan-forged-in-140-million-theft
[2] https://www.theblock.co/post/130793/on-chain-analyst-claims-crypto-com-hack-was-closer-to-33-million; https://www.bloomberg.com/news/articles/2022-01-17/crypto-com-suspends-withdrawls-after-unauthorized-activity?sref=f7rH2jWS

provided custody services for its clients, who used fiat currency to purchase crypto on Voyager's platform with the intent of receiving a return on their investment. Voyager portrayed themselves as a reputable, reliable company, subject to meaningful oversight: "Publicly traded, licensed and regulated." The firm claimed that their customers USD 'deposits' were held by its FDIC-insured banking partner, Metropolitan Commercial Bank (MCB) – but neglected to explain that the cash in question was protected in the event MCB failed, not Voyager. We now know Voyager commingled its customer funds with its own and became over leveraged due to its rehypothecation of customer assets for lending purposes. And, when Voyager went into bankruptcy after the collapse of Three Arrows Capital, due to a loan Voyager made to that firm, many Voyager customers learned that their assets were not protected in event of bankruptcy and became unsecured creditors overnight. Many Voyager customers have yet to recoup their investments due to prolonged bankruptcy proceedings and have effectively lost tens or hundreds of thousands of dollars' worth of their investments.[3]

There are many, many other examples that we could highlight; the bottom line is that under current conditions, crypto investors face heightened risks and potentially significant losses when relying on crypto firms to provide custody of their investments.

2. **Custody is a bedrock issue when it comes to investor protection** – Custody of client assets is not an esoteric or marginal aspect of financial management or investment activity. It is core to the role that financial intermediaries play in finance. Investment advisers must ensure the assets they maintain for their clients are protected against theft, loss, misuse or misappropriation, and that in the event of insolvency, they are protected against loss. Moreover, if investors do not have confidence that the funds they've entrusted to investment advisers and custodians are safe from theft or misuse and secure in the event of insolvency, they will be less likely to entrust their assets to others, which will in turn slow the wheels of financial markets overall.

   According to some investment firms, "The Securities and Exchange Commission ("SEC") views the custody rules as one of the most critical sections of the Advisers Act, and it has allocated investigation and enforcement resources accordingly."[4] The SEC has highlighted compliance with the custody rule several times in the last decade or so as a priority in annual examinations, produced risk alerts regarding non-compliance with the existing custody rule, and has updated the rule both in 2003 and 2009 to ensure it is aligned with new developments in financial markets and fosters meaningful compliance for advisers and custodians as ultimately protection for investors.[5]

   Critics of the proposed amendments to this rule who might suggest the new standards are too onerous for firms providing custody for crypto assets would do well to recognize that custody has been a challenge for traditional finance as well. The SEC's 2013 risk alert entitled "Significant Deficiencies Involving Advisor Custody and Safety of Client Assets" reported that there was at the time "widespread and varied non-compliance with elements of the [then] Custody Rule," with about one-third of all adviser examples containing "custody-related issues."[6]

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[3] https://forkast.news/what-did-voyager-do-with-your-crypto-money/; https://www.mintz.com/insights-center/viewpoints/2831/2022-07-18-charting-new-and-familiar-territory-voyager-crypto#:~:text=Much%20like%20a%20traditional%20trading,earn%20interest%20on%20the%20deposit.
[4] https://www.houlihancapital.com/why-you-need-to-understand-the-custody-rule/
[5] https://beachstreetlegal.com/the-custody-rule-its-not-just-for-custodians/
[6] https://beachstreetlegal.com/the-custody-rule-its-not-just-for-custodians/

To be sure, this is not an argument for relaxing custody rules; rather, it is an argument against weakening this amended rule proposal for the sole benefit of firms providing custody for crypto assets. Doing so risks not only providing investors with less protection should they and their advisers seek investments in crypto assets, but might put firms and clients that choose not to invest in crypto assets at a competitive disadvantage, which could in turn foster a race to the bottom, with investment advisers incentivized to seek out investments in crypto assets not because it's in the best interests of their clients but because it reduces their custody obligations and related compliance costs. This rule at its most essential simply makes the case that the standard of care for crypto asset custody should be consistent with that required for custody of other financial assets maintained by registered investment advisers on behalf of their clients.

3. The path for compliance that this updated rule creates is narrow, but fair.

These amendments to the custody rule should also come as little surprise to the crypto industry. Custody has been an issue that has generated controversy and challenges both operationally and ideologically for some time within the crypto industry itself, and agencies have flagged for years that changes would be coming.

Regarding signaling from agencies, there has been guidance as far back as 2019 if not earlier on the risks associated with crypto custody and the need for more rigorous practices. To name a few examples, the SEC and FINRA issued a joint staff statement in 2019 on digital asset custody; the OCC's Interpretive Letter 1179 issued in November 2021 cautioned banks about the risks associated with crypto custody, and a 2022 SEC Staff Accounting Bulletin required public companies that were holding crypto assets in custodial capacity to provide certain disclosures and keep those assets as liabilities on their balance sheets to address and mitigate associated risks.[7]

Regarding custody as practice, Bloomberg journalist Matt Levine recently summed up the current situation with crypto custody as follows:

> "Another point is, you know, the SEC is not wrong. Crypto exchanges do have a long history of losing customer assets, and of landing in bankruptcy with customers who are very confused specifically about custody questions. Crypto exchanges mostly create the impression that they segregate customer assets, and then mostly end up with customers who are unsecured creditors in bankruptcy. Even Coinbase, which does seem to keep its customers' crypto segregated, can't definitively promise them that they won't be unsecured creditors in bankruptcy: The legal regimes for crypto custody are just less settled than the regimes for securities custody."[8]

Crypto firms also have acknowledged that custody is an issue of particular importance within a decentralized financial system. In the traditional financial system, the Depository Trust Company (DTC) plays a central intermediary role, tracking ownership of various investment holdings. That centralization confers some benefit, in that there is one 'ledger' that holds a record of ownership. Given that the record of ownership for digital assets exists on multiple distributed ledgers, depending on which assets are being held or traded, the potential for confusion to arise is greater, which means custody takes on greater importance in a crypto context.

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[7] Proposed SEC Custody Rule Amendments Could Drive Structural Changes in the Digital Asset Industry | Paul Hastings LLP
[8] https://www.bloomberg.com/opinion/articles/2023-02-16/the-sec-comes-for-crypto-custody?sref=f7rH2jWS

Regarding larger industry views on custody, even major crypto firms have at times advised crypto investors to pursue self-custody in response to uncertainty about crypto custody on platforms. As the FTX collapse was unfolding, Cointelegraph reported that high profile crypto investors and founders such as Changpeng Zhao (CZ) and Michael Saylor were encouraging investors to pursue self-custody of their assets as a safeguard against problems with custody on key platforms: "Binance CEO Changpeng Zhao said self-custody is a "fundamental human right," while Michael Saylor said self-custody is necessary to prevent powerful actors from accumulating and abusing power."[9] More recently, in January 2023 crypto firm Juno advised its customers to self-custody their assets and stop trading on their platform due to unspecified concerns with their partner organization that was providing custody on behalf of Juno platform users.[10]

The longstanding crypto adage "not your keys, not your coins" is a direct reference to self-custody of crypto assets and reflects how swathes of the crypto culture and industry have strongly held views about the role custody plays in crypto investing. To be clear, AFREF and DPEF have concerns about self-custody of crypto assets; among other things, from a consumer protection standpoint self-custody leaves consumers with little recourse or support if their private keys are lost, stolen or destroyed. In fact, paradoxically, crypto founder CZ has also been quoted saying that "For most people, for 99% of people today, asking them to hold crypto on their own, they will end up losing it."

Given these points of context, it seems very clear that crypto investors and market participants would benefit from clear, robust rules for crypto custody that would ensure custody options for crypto investors and their advisers are safe, secure and reliable. And, as laid out in the guidance for the updated rule, there are today entities that exist which do meet, or may be able to meet, the standards required for qualified custodians under this new rule. Some firms even believe more robust standards might lead to more investor interest in crypto, as a result of more robust oversight.

A number of crypto firms and firms associated with mainstream finance appear to agree with this assessment. For example, Mike Belshe, the CEO of Bitgo, a crypto firm that provides custody services and whose company holds trust charters in New York and South Dakota, was quoted in the media saying this proposal was "generally bullish" for crypto by providing advisers a path forward on how to get into the market.[11] A month after these rules were proposed, NASDAQ confirmed publicly it still had plans to launch a crypto custody service in the second quarter of this year, via a limited purpose trust charter with NY DFS.[12] Even Coinbase, which has an embattled relationship with the SEC, has gone on record claiming that its Coinbase Custody Trust Company (CCTC) would comply with this rule, saying, "After today's SEC proposed rulemaking, we are confident that it will remain a qualified custodian."[13]

Firms such as Bank of New York Mellon have been providing custody services that appear to be aligned with the standards of this rule. Indeed, in October 2022 Bank of NY Mellon's own research determined that 40% of institutional investors hold crypto and that it expected that figure to climb to 55% in the next two to five years, seeming to suggest the firm saw the need for custody services to climb in concert.[14]

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[9] https://cointelegraph.com/news/cz-and-saylor-urge-for-crypto-self-custody-amid-increasing-uncertainty
[10] https://cryptopotato.com/crypto-platform-advises-users-to-withdraw-funds-amid-custody-issues/
[11] https://www.politico.com/newsletters/morning-money/2023/02/16/genslers-crypto-cleanup-gets-custodial-00083169; https://www.coindesk.com/consensus-magazine/2023/03/08/the-secs-custody-rule-would-be-a-net-positive-for-crypto/
[12] https://www.coindesk.com/business/2023/03/24/nasdaq-aiming-to-debut-crypto-custody-service-by-q2-end-bloomberg/
[13] https://www.politico.com/newsletters/morning-money/2023/02/16/genslers-crypto-cleanup-gets-custodial-00083169
[14] https://www.pymnts.com/cryptocurrency/2022/bny-mellon-leads-big-banks-into-crypto-custody/

Anchorage Digital is another firm registered as a trust by the OCC that appears to be able to meet the custody standards in this rule.[15]

To be clear, our organizations remain highly skeptical of the use cases that crypto assets are purported to provide, both on their own and relative to other means of improving financial inclusion or wealth creation. We also remained concerned that some of the risks presented by crypto assets are not merely due to inadequate regulatory oversight but may be intrinsic to the products or predominant business models that are present throughout the industry. As such, we would encourage the SEC to coordinate closely with regulated entities in this space as well as with banking regulators to ensure that those qualified custodians that do end up providing custody services for crypto assets and their investors are monitored closely and are adequately prepared to deal with the risks these assets have and will likely continue to pose.

However, given that this proposal addresses a critical risk that investors face today given the crypto industry poor track record and risky practices, and given that the proposed amendments seek to bring industry players up to existing standards and does so within the existing regulatory framework, instead of creating bespoke regulations for crypto custody that would likely invite arbitrage or legitimize poor custody practices found within the industry, we support the introduction and finalization of these amendments as currently proposed.

Thank you for the opportunity to comment on this rule. We would be happy to answer any further questions you have about our submission.

Sincerely,

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[15] https://www.coindesk.com/policy/2023/02/15/sec-proposal-could-bar-investment-advisers-from-keeping-assets-at-crypto-firms/