May 5, 2023

**BY ELECTRONIC SUBMISSION**

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

Re: File No. S7-04-23, RIN 3235–AM32, Safeguarding Advisory Client Assets

Dear Ms. Countryman:

Andreessen Horowitz ("a16z") appreciates the opportunity to comment on the proposal by the Securities and Exchange Commission ("Commission")\(^1\) to address how investment advisers safeguard client assets (the "Safeguarding Rule"). Our principal concern is that without a broader exception to allow registered investment advisers ("RIAs") to self-custody client crypto and other assets, the Safeguarding Rule is unworkable. We fear that absent a suitable self-custodial exception, the proposed Rule would effectively ban RIAs from holding and transacting in crypto assets for clients. We do not believe the Commission could have intended such a drastic and misguided step, and so we suggest measures by which the Commission can support RIAs to securely custody client assets, consistent with the aims of the Safeguarding Rule.

In support of a broader self-custodial regime, we question whether the Commission has adequately considered whether, and how the Safeguarding Rule will work for crypto assets that have participatory features such as staking, or voting. Similarly, we question whether the

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\(^1\) Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672 (Mar. 9, 2023) ("Safeguarding Rule Proposal" or "Proposal").
Commission has assessed the feasibility, in the crypto asset context, of its proposal that custodians indemnify RIAs against the risk of loss.

Further, and in addition to suggesting that the Commission create a broad and robust regime for the self-custody of crypto and other assets by RIAs, we also raise concerns regarding the Commission’s proposed ban on the trading of crypto assets on platforms by RIAs. We believe this proposed prohibition to be illegal, infeasible, and dangerous, for reasons we explain later in this letter.

We believe that if adopted in its current form, the Safeguarding Rule could effectively entirely prohibit RIAs from transacting in crypto assets for their clients — a result that would frustrate the orderly development of the nascent crypto asset markets, while harming rather than protecting investors. We believe that this very unfortunate and unintended outcome stems from the Commission’s failure, in breach of the Administrative Procedure Act, to suitably assess the features and attributes of crypto assets and crypto asset markets. Relatedly, we also believe that the Commission’s failure to consider key aspects of crypto assets and their markets has led to its failure to evaluate practical, well-established alternatives to the sweeping restrictions proposed in the Safeguarding Rule.

As one of Silicon Valley’s leading venture capital firms with over $35 billion in committed capital, a16z has been investing in crypto for many years, and today, we manage multiple dedicated crypto/web3 pooled vehicles of over $7.5 billion of committed capital across this family of funds. AH Capital Management, L.L.C., a registered investment adviser, serves as adviser to our fund family, including our crypto-focused funds. As the earliest and largest investor in many crypto and web3 companies and projects, and as one of the largest investment advisers in the advanced technology space, a16z is well-positioned to evaluate the potential impact of the Safeguarding Rule on RIAs, and on RIAs holding crypto assets, in particular.
We have always been, and we remain open to working with the Commission towards the development of stable, secure crypto asset markets. In that spirit, we offer our comments below.

INTRODUCTION AND EXECUTIVE SUMMARY

On February 15, 2023, the Commission proposed the new Safeguarding Rule under the Investment Advisers Act, 1940 (the “Advisers Act”). The Safeguarding Rule would require an RIA to maintain all client assets, including crypto assets, with a “qualified custodian.” The proposed Rule would also require RIAs to obtain reasonable assurances from qualified custodians that, among other things, the custodian will indemnify the RIA against losses caused by the qualified custodian’s negligence, recklessness, or willful misconduct.

While the proposed Rule would permit an RIA to self-custody privately-offered securities and physical assets if the RIA reasonably determines that a qualified custodian cannot maintain possession or control of such assets, it does not permit RIAs to do so with respect to crypto asset securities. In addition, the Safeguarding Rule would not permit an RIA to trade a crypto asset on a centralized trading platform, because such platforms are not qualified custodians, and trading the asset would entail moving it out of custody.

a16z has serious concerns about the Safeguarding Rule and the absence of a broader, flexible self-custodial exception that would make the proposed Rule workable for crypto and other assets. These concerns are summarized here and described in detail below:
The Self-Custodial Exception Should Apply to All Assets Where No Qualified Custodian is Reasonably Available

- The Commission articulates no reason why self-custody should only be permitted for privately-offered securities and physical assets. In particular, the Commission does not explain why the exception should not be available for crypto assets, many of which may have features that raise challenges similar to privately-offered securities, or could themselves be privately offered. The Commission does not determine whether adequate custodial options exist for the crypto assets held by RIAs, and does not consider the economic implications of the proposed Safeguarding Rule for crypto assets.

- Absent a suitable self-custodial exception, RIAs will not be able to make productive use of crypto assets with economic or governance rights, such as assets with “staking” features, or assets which permit voting. The failure to exercise such rights on behalf of their clients may, in turn, cause RIAs to violate their fiduciary duties to their clients and therefore cause harm to investors.

- Given the nascent insurance market for crypto assets, qualified custodians may not be able to indemnify RIAs against the risk of loss. The Commission has not adequately studied how feasible indemnification is for crypto asset custodians. Where indemnification is infeasible, the Commission should permit RIAs to self-custody crypto and other assets.

- Importantly, if the self-custody exception were broadened to cover all assets for which no qualified custodian can reasonably be found, the Safeguarding Rule has checks to guard against the abuse of the exception. These checks include the RIA’s duty to determine the unavailability of a custodian, and to review this finding frequently; the duty to implement safeguarding procedures for self-custodied assets; and the periodic audit requirement.
The Prohibition Against RIAs Trading Crypto Assets on Centralized Trading Platforms is Illegal, Unworkable and Dangerous

- The proposed prohibition against RIAs trading crypto assets on centralized platforms will likely deprive RIA clients of the most liquid trading venues for these assets. Without access to such trading venues, RIAs will find it difficult to meet their fiduciary duty of best execution, harming RIA clients whose trades cannot be optimally executed.

- The Commission has not considered the economic implications of the proposed prohibition on trading crypto assets on centralized platforms. If deprived of such trading platforms, RIAs trading crypto assets may have to trade client assets through market makers. As a result, their clients will likely incur significantly higher fees, and price discovery for such assets will be impaired. Smaller RIAs and their clients will likely be worst affected by higher market maker transaction fees.

a16z urges the Commission to address these concerns by reproposing the Safeguarding Rule, particularly as it relates to crypto assets. As part of such reproposal, the Commission should:

1. extend the proposed self-custodial exception to cover all assets for which no suitable qualified custodian can be reasonably found;

2. permit RIAs to self-custody crypto assets if no qualified custodian can be reasonably found who will exercise the participatory rights associated with these assets in a safe and secure manner;

3. remove the indemnification requirement; and

4. clarify that RIAs may, without violating the Safeguarding Rule, trade crypto assets on decentralized exchanges, as well as on centralized exchanges that meet security parameters.
DISCUSSION

I. THE SELF-CUSTODIAL EXCEPTION TO THE SAFEGUARDING RULE SHOULD COVER ALL ASSETS FOR WHICH QUALIFIED CUSTODIANS ARE NOT REASONABLY AVAILABLE

The proposed Safeguarding Rule would require RIAs to maintain client assets with a qualified custodian at all times. The Rule proposes only a single, narrow exception to this requirement — RIAs are permitted to self-custody privately issued securities and physical assets, provided they reasonably determine that a qualified custodian cannot maintain possession or control of such assets. To justify this exception, the Commission notes that “[t]here are certain impediments to transferability typically associated with certain privately offered securities—specifically, the need to obtain the consent of the issuer or other securities holders prior to any transfer of ownership—that make certain of these assets less susceptible to some of the risks the rule is designed to address.”

We do not disagree with the Commission’s proposal to except privately-offered securities and physical assets from the Safeguarding Rule’s qualified custodian requirement. We question, however, why the Commission must confine the proposed exception to privately-offered securities and physical assets alone. For example, the Commission gives no indication that it has considered whether there may be similar attributes to crypto assets that might make it suitable to extend the self-custodial exception to such assets. For example, some crypto asset non-securities cannot be transferred without the consent of third parties — this feature of the crypto asset closely resembles a privately-offered security. Because the asset is not a security, however,

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2 "Importantly, however, to comply with the proposed rule, an adviser with custody of client crypto assets would generally need to ensure those assets are maintained with a qualified custodian that has possession or control of the assets at all times in which the adviser has custody." See 88 Fed. Reg. at 14,689.
3 See proposed Rule 223-1(b)(2).
RIAs would not be able to self-custody it. Thus, two assets with essentially identical difficulties around custody would be treated completely differently under the proposed Safeguarding Rule.

The Proposal states that the Commission believes “that the bulk of advisory client assets are able to be maintained by qualified custodians,” but provides no explanation, in any detail, for this belief, particularly in the context of crypto assets. The Commission’s proposed self-custodial exception is thus arbitrarily restricted to privately-offered securities and physical assets, instead of being available for all assets that cannot be held by a qualified custodian.

We note that the self-custodial exception that the Commission proposes already has a number of built-in safeguards that will prevent abuse of the self-custodial exception. We also note that without a more expansive self-custodial exception, RIAs will be unjustifiably prevented from making productive use of a vast range of crypto assets, thus harming RIA clients, including many retail investors. The Commission thus fails to consider a suitably flexible self-custodial exception as an alternative to the proposed Safeguarding Rule. The Commission also fails to provide even the most basic estimate of the costs of not adopting a broader and more flexible self-custodial exception to the proposed Safeguarding Rule. These failures violate the Administrative Procedure Act, and weaken the proposed Rule.

We discuss these matters further below.

A. The Commission Provides No Reason Why the Self-Custody Exception Should be Limited to Privately-Offered Securities and Physical Assets

The Commission asks: “Should we limit the [self-custodial] exception to privately offered securities and physical assets as proposed?” We answer that question firmly in the negative.

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5 Id.
6 Id. at 14,711.
The Commission asks us to explain our answer. We will certainly explain our answer, but we will start by asking why the Commission does not explain its curious insistence on narrowing the self-custodial exception to privately-offered securities and physical assets alone. What, for example, is the basis for the Commission’s conviction that “that the bulk of advisory client assets are able to be maintained by qualified custodians?” The Commission provides no explanation of whether the broad range of assets that would be covered by the proposed Safeguarding Rule are capable of being maintained by qualified custodians.

Conspicuous by its absence is the Commission’s failure to consider in much greater detail the complexities associated with the custody of crypto assets. Elsewhere in the Proposal, the Commission states its “understanding” that one national bank regulated by the Office of the Comptroller of the Currency (“OCC”), four OCC-regulated trusts, approximately 20 state-chartered trusts and limited purpose banking entities, and at least one Futures Commission Merchant currently offer custodial services for crypto assets. However, the Commission makes no attempt to examine this data further, or even to verify it. It does not ask, for example, what crypto assets are supported by these custodians. Nor does it ask if the crypto assets supported by these custodians correspond to the crypto assets held by RIAs for their clients. It does not acknowledge the reality that crypto assets are themselves a functional technology, so that not all crypto assets can be custodied in the same manner. It does not acknowledge that custodians incur considerable cost in assessing whether a particular crypto asset can be custodied.

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7 Id.
8 Id. at 14704.
9 Id. at 14,740. Notably, among these trusts, the Commission includes Protego Trust Company (see 88 Fed. Reg. 14,691, n. 138), but that trust appears to have since gone out of business, thereby reducing further the small number of qualified custodians for crypto assets. See Jon Hill, Digital Asset Bank Hits Wall in Bid to Secure OCC Charter, (Mar. 17, 2023) at https://www.law360.com/articles/1587428/digital-asset-bank-hits-wall-in-bid-to-secure-occ-charter.
The Commission also makes no effort to ask whether the number of qualified custodians for crypto are remotely adequate for the crypto asset management industry. The Commission notes that “[t]he industry-reported market capitalization for crypto assets experienced a rapid growth from $1 billion in 2018 to $1 trillion in 2021.”\(^\text{10}\) It does not ask whether this explosion in crypto assets has been accompanied by similarly rapid growth in crypto asset custodians. The Commission nowhere examines whether there are too few qualified custodians for too many crypto assets, and whether this creates concentration risk and systemic hazards for the crypto asset industry, for RIAs, and for their clients. The Commission notes the fact that many custodians may refuse to custody physical assets because of the nature of these assets, and because of the expenses of custody, but the Commission never examines whether the same considerations might also hinder the custody of crypto assets.\(^\text{11}\)

Having failed to determine whether there are enough qualified custodians for the crypto asset industry, and whether these custodians serve an adequate number of crypto assets, the Commission naturally fails to appreciate the need for a broader self-custodial exception. The Commission cannot merely proceed on the assumption that it is theoretically possible for a qualified custodian to custody crypto assets (without discussing specific assets). Nor is it sufficient for the Commission to reassure itself, again without specific data, that “[t]he market for crypto asset custodial services continues to develop.”\(^\text{12}\) The Commission must instead assess whether compliance with the proposed Rule is practically feasible for RIAs that maintain various crypto assets for clients, and what the costs and risks of such compliance are.\(^\text{13}\)


\(^{11}\) Id. at 14,704.

\(^{12}\) Id.

\(^{13}\) See, e.g., *Business Roundtable v. SEC*, 647 F.3d 1144, 1150 (“Although the Commission acknowledged that companies may expend resources to oppose shareholder nominees, see 75 Fed. Reg. at 56,770/2, it did nothing to estimate and quantify the costs it expected companies to incur; nor did it claim estimating those costs was not
The Commission’s own long-standing guidance directs its staff engaged in a rulemaking to articulate the appropriate economic baseline for a rulemaking by describing the state of the world in the absence of the proposed Rule, against which to measure the likely impact of the proposed rule and the principal alternative regulatory approaches. Here, the Commission provides no comparison of what the impact would be of requiring RIAs to maintain crypto assets with qualified custodians, as opposed to permitting RIAs to self-custody such assets. If the Commission felt that it was unable to estimate these costs accurately, it should at least have candidly acknowledged that fact in the Proposal.

B. Unless the Proposed Self-Custody Exception is Expanded, RIAs Will be Prevented from Making Productive Use of Many Crypto Assets

Crypto assets often include participatory features or rights that are central to their design. To exercise these participatory rights, crypto asset holders may need to temporarily move the asset out of custody. For example, many crypto assets use a “staking” mechanism, possible, for empirical evidence about expenditures in traditional proxy contests was readily available. Because the agency failed to ‘make tough choices about which of the competing estimates is most plausible, [or] to hazard a guess as to which is correct,’ Pub. Citizen v. Federal Motor Carrier Safety Admin., 374 F.3d [1209] 1221[(D.C. Cir. 2004)], we believe it neglected its statutory obligation to assess the economic consequences of its rule . . . .”


15 Take, for example, Ethereum, a decentralized blockchain with smart contract functionality, which uses staking to validate transactions. Ethereum allows anyone to deploy permanent and immutable decentralized applications onto it, with which users can interact. Ethereum also allows users to create and exchange non-fungible tokens, which are unique tokens representing ownership of an associated asset or privilege. Additionally, many other crypto assets utilize the ERC-20 token standard on top of the Ethereum blockchain and have utilized the platform for the creation of their own tokens. See Ethereum Whitepaper, (Apr. 7, 2023) available at https://ethereunm.org/en/whitepaper/. In November 2021, one source estimated that there were over 450,000 tokens built using the ERC-20 standard. (See Exploring the ERC-20 Token Standard, (No. 9, 2021), available at
which involves committing the crypto assets in order to validate transactions on their underlying protocol. Stakers temporarily deposit tokens, and an algorithm determines which stakers get to verify transactions, and receive rewards for successfully verifying transactions. The staked crypto assets typically cannot be used or moved while the staking process is ongoing. Some digital asset protocols may treat stakers who fail to verify transactions punitively by “slashing” or deducting a part of their stake.

Crypto assets may also have “yield” features or other income-based or other earning opportunities. For instance, by depositing stablecoins into a digital account, investors can receive a periodic yield on their deposits. In addition, certain protocols may offer an additional subsidy, in the form of a new token, on top of the yield that it charges the borrower and pays to the lender. Many of these, and other similar economic rights associated with tokens may require crypto assets to be “locked up” in protocols for some period of time, until the yield or other economic benefit is obtained.

These economic rights are important features of many crypto assets, and may be vital to the functioning of the blockchain on which the token is issued. Beyond economic rights, however, crypto assets may offer voting or other governance rights to their holders. In particular, crypto assets may grant holders the right to vote on protocol development or on

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other significant milestones. As with economic rights, exercising governance rights connected to crypto assets may require moving the asset out of custody.\textsuperscript{19}

The proposed Safeguarding Rule entirely ignores these participatory features of crypto assets, instead requiring RIAs to maintain client crypto assets with qualified custodians at all times. Yet, complying with the Safeguarding Rule will prevent RIAs from exercising, on behalf of their clients, participatory rights that are integral to the crypto assets that RIAs hold. What will ensue is not merely confusion, and mismanagement – it may entail the potential violation by many RIAs of their fiduciary duties. Most important, however, is the net effect — that harm is done to RIA clients i.e., American investors.

As fiduciaries, RIAs must always serve the best interest of their clients and not subordinate their clients’ interest to their own.\textsuperscript{20} The Commission expressly requires RIAs to consider “an investment product’s or strategy’s investment objectives, characteristics (including any special or unusual features), liquidity, risks and potential benefits, volatility, likely performance in a variety of market and economic conditions, time horizon, and cost of exit—to consider when determining whether a security or investment strategy involving a security or securities is in the best interest of the client.”\textsuperscript{21} (Emphasis ours) In the context of traditional securities, Commission Staff note that RIAs that have the authority to vote proxies must do so in the best interests of their clients.\textsuperscript{22} It would seem odd if this duty did not similarly attach to RIAs holding crypto asset securities, or even crypto assets more generally.

\textsuperscript{19} Walker & Maitra, \textit{Crypto Asset Custody}.
\textsuperscript{21} Id. at 33674.
As currently drafted, the Safeguarding Rule would require RIAs to either comply with the proposed Rule or deploy crypto assets in the best interests of their clients. This is an impossible choice, and no matter how they choose, RIAs may run afoul of the Advisers Act. Nor are RIAs likely to be able to delegate these economic or governance duties to qualified custodians. Qualified custodians are unlikely to be willing to risk losses for unsuccessful staking, or to make voting decisions for RIA clients – indeed, no qualified custodian currently performs these functions with respect to traditional securities.

Fortunately, a relatively minor change to the proposed Safeguarding Rule will likely address these difficulties. The Commission could provide for a broader self-custodial exception that requires RIAs to (1) assess whether a crypto asset has associated participatory rights which an RIA must exercise in its clients’ interest; and (2) determine whether there is a qualified custodian willing and able to exercise those rights in a secure manner, and in the best interests of the RIAs’ clients. If the RIA determines that the crypto asset has such economic or governance rights and that no suitable qualified custodian exists who will both custody the asset and exercise its associated rights, the Commission should permit the RIA to self-custody such assets, subject to the safeguards already provided for in the Proposed Rule. The Commission should also permit RIAs self-custodying such assets to deploy assets out of self-custody solely for the purpose, and for the limited period required, to exercise the participatory rights associated with these assets.

If, on the other hand, the Commission continues to ignore the very significant economic or governance rights associated with a vast number of crypto assets, the Commission risks causing significant harm to the investor clients of RIAs as well as placing RIAs on a path to violating the Advisers Act. Perhaps even more importantly, the Commission risks giving the
impression that it has simply ignored a vital economic question, in violation of the Administrative Procedure Act.  

C. Many Crypto Asset Custodians Likely Cannot Provide the Proposed Indemnities — Making a Broader Self-Custody Exception Necessary

There are, by the Commission’s own count, no more than 25 entities that may be qualified custodians for crypto assets, although the Commission puts forward no data as to whether these qualified custodians serve the crypto assets that many RIAs hold. The proposed Safeguarding Rule would likely further reduce the custodial options open to RIAs by requiring RIAs to obtain reasonable assurances from qualified custodians that, among other things, the custodian will indemnify the RIA against losses caused by the qualified custodian’s negligence, recklessness, or willful misconduct.

There are not many qualified custodians for crypto custody, and there are likely to be fewer still who will be in a position to provide the required indemnification. The insurance market for crypto assets and crypto asset custodians is a nascent one — there are a small number of providers, providing cover for a small number of assets. Insurance cover can be expensive, the nature of coverage varies widely across insurers, assets and jurisdictions, and suitable coverage is often unavailable for many assets. Further, any costs associated with such insurance coverage incurred by custodians would likely be passed on to RIAs.

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23 Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983). “Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.” (Emphasis ours.)

24 Mengqi Sun, Insurance Providers Rethink Their Approach to Crypto, The Wall Street Journal, (May 25, 2022); Parma Bains et al, Regulating the Crypto Ecosystem: The Case of Unbacked Crypto Assets, (Sept., 2022), noting that “The terms and conditions for crypto asset insurance can vary from policy to policy, with some policies delivering little or no benefit.”
In its cursory cost-benefit analysis of the indemnification requirement, the Commission entirely ignores the costs of the requirement for RIAs holding crypto assets and for crypto asset custodians. The Commission’s failure to consider these costs is particularly puzzling, because the Commission specifically observes that “the negotiating power of the investor appears to play an outsized role in the type of misconduct for which a custodian will provide indemnity and that retail investors appear to have limited ability to negotiate these terms effectively.” Despite this observation, the Commission makes no attempt to study how this imbalance in negotiating power might apply in the context of crypto assets, where a relatively large number of RIAs appear to be served by a relatively small number of qualified custodians. Nor does the Commission distinguish between the negotiating power of large and small RIAs, and whether indemnification may be particularly difficult for smaller RIAs with very limited negotiating power. What are the consequences for the clients of smaller RIAs holding crypto assets, if these smaller RIAs are unable to find a qualified custodian willing to provide the required indemnity? And what are the consequences for investor protection and for competition among RIAs and custodians? On these, and many other points, the Commission and the Proposal are silent.

Effectively admitting the practical difficulties that may be created by an inflexible and universal requirement to indemnify, the Commission agrees that this may result in higher costs and a shrinkage in the number of custodians. Yet the Commission provides no exception to the indemnification requirement, choosing instead to observe, without data, that “on balance”, “the proposed rule promotes key protections to which every custodial customer should be entitled when the adviser has custody.”

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25 Id. at 14,745-46.
27 Id. at 14,692. “To the extent an element is not typical for a particular custodian, it may create practical difficulties (e.g., higher costs of compliance, or market contraction for custodial services).”
28 Id.
These sweeping observations, unsupported by any evidence, cannot serve to discharge the Commission’s obligations under the Advisers Act. Section 202(c) of the Act requires the Commission, during any rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.29 Here, the Commission has put forward absolutely no data on whether the proposed indemnification could potentially reduce competition among crypto asset custodians, put at risk smaller RIAs and their clients, and make it near-impossible for many RIAs to hold crypto assets, even when these assets are clearly in the best interest of their clients. In the absence of such data, the Commission should remove the proposed indemnification requirement.

Alternatively, the Commission can remedy the disparate and anti-competitive effects of the proposed indemnification requirement by permitting RIAs to self-custody assets (including crypto assets) where no qualified custodian can be reasonably found to provide the proposed indemnity or other assurances. RIAs should be permitted to self-custody such assets for which no indemnity can be given, consistent with the safeguards required for self-custody under the Safeguarding Rule. The Commission entirely fails to consider self-custody as a reasonable alternative where qualified custodians cannot or will not provide the required assurances. The failure to consider this reasonable alternative weakens the proposed Rule – the failure to adopt such an alternative may weaken the Rule fatally.

D. Even If the Proposed Self-Custody Exception Is Expanded to Cover Crypto Assets, There are Safeguards to Prevent Abuse of the Exception

The Commission’s discussion around the self-custodial exception suggests that the Commission has concerns about creating an exception that effectively negates the proposed

Safeguarding Rule.\textsuperscript{30} The Commission also expresses the concern that the self-custodial exception may not adequately protect an advisory client from the broad types of risks the custody rule is intended to address: chiefly, misappropriation.\textsuperscript{31} These concerns are, however, misplaced, and would be adequately addressed even if the self-custody exception were expanded to include crypto assets beyond privately-offered securities and physical assets.

First, in order to invoke the self-custody exception for any asset, an RIA must first determine in writing that a qualified custodian cannot maintain possession or control of the asset. The Commission also notes that this determination depends on the facts and circumstances, and that these determinations would necessarily evolve over time as assets and the custodial industry change.\textsuperscript{32} An adviser’s reasonable determination of whether a qualified custodian is able to maintain possession or control of a particular asset would generally involve an analysis of the asset and the available custodial market, and the frequency of this determination would depend on the particular assets and the facts and circumstances.\textsuperscript{33}

Thus, in a fast-moving market such as the crypto asset market, there may be frequent changes to both assets available, as well as custodial options. In order to comply with the proposed Safeguarding Rule, RIAs would have to review custodial arrangements frequently – thus preventing RIAs from using the self-custody exception in perpetuity, even after the crypto custodial market has developed beyond the relatively thin options currently available.

\textsuperscript{30} See 88 Fed. Reg. at 14,705. “When this exception was adopted, the size of the privately held securities market was much smaller than it is now on an absolute basis as well as in relation to the size of the publicly traded securities market. In addition, the type, nature, structure, and prevalence of private issues have also changed and expanded in recent years, all of which have led the Commission to reconsider the current rule’s exception.” (Internal citations omitted.)

\textsuperscript{31} Id.

\textsuperscript{32} Id. at 14,707.

\textsuperscript{33} Id.
Second, to rely on the exception, RIAs must reasonably safeguard self-custodied assets from loss, theft, misuse, misappropriation, or the RIA’s financial reverses, including insolvency. The specific procedures implemented to safeguard assets may vary depending on the asset, and RIAs may look to reasonable commercial standards to develop those procedures. In the context of crypto assets, those reasonable commercial standards are coalescing swiftly, so that there is an emerging consensus around safeguarding procedures for many assets. Most entities custodial crypto assets agree on the use of measures such as multi-system approval mechanisms, multi-party computation, the use of hardware security modules, “air-gapping,” and annual audits. The practical implication of this emerging consensus is that permitting RIAs to self-custody crypto assets is unlikely to create an “anything goes” regime, with widespread disparities in self-custodial practices.

Third, the Safeguarding Rule would require RIAs self-custodying assets to undergo an annual surprise examination or rely on the audit provision. Unlike the current custody rule, however, the proposed Rule would require each asset not maintained with a qualified custodian to be verified. This proposed change from the existing custody rule is designed to address the Commission’s concerns that a loss of self-custodied assets could go undetected for an extended period of time. One attribute of crypto assets that mitigates the Commission’s concern is that crypto assets are visible to those with an internet connection, which means holdings can be reviewed at any time. Notwithstanding this, the surprise examination or audit requirement in the proposed Rule would continue to guard against the misappropriation of crypto assets, as it does other assets covered by the exception.

34 Walker & Maitra, Crypto Asset Custody at 11-12.
II THE PROPOSED PROHIBITION OF ON-PLATFORM TRADING OF CRYPTO ASSETS BY RIAS IS UNWORKABLE, AND IN VIOLATION OF THE ADMINISTRATIVE PROCEDURE ACT

The Commission proposes to prohibit RIAs from trading client crypto assets on centralized trading platforms. Centralized trading platforms are not qualified custodians, the Commission states, and therefore RIAs that move crypto assets to platforms for trading would violate the Safeguarding Rule.36

In proposing this inflexible, sweeping prohibition, the Commission does not appear to have considered, even in passing, its likely impact on RIA clients, and its effects on orderly markets and competition between trading venues. The Commission has not considered whether compliance with this proposed prohibition might place RIAs in violation of their fiduciary duties. The Commission does not consider the alternatives to a blanket ban on platform-based trading; indeed the Commission does not appear to have considered whether there are any alternatives at all. The breadth of this proposed prohibition is likely to be matched only by its profoundly adverse effects, on RIAs, on RIA clients, and on crypto asset markets.

A. The Proposed Prohibition on Platform-Based Trading of Crypto Assets May Cause RIAs to Violate the Fiduciary Duty of Best Execution

As fiduciaries, RIAs owe their clients a duty of care. The Commission has clarified that this duty of care includes, among other things, the duty to seek best execution of a client’s transactions where the adviser has the responsibility to select broker-dealers to execute client trades.37 The fiduciary duty of best execution requires an RIA to seek the execution of

36 Id. at 14,689.
transactions for each of its clients such that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances. An RIA satisfies this duty by seeking to execute client securities transactions to maximize value for the client under the particular circumstances occurring at the time of the transaction. Thus, the determinative factor for best execution is “whether the transaction represents the best qualitative execution.”

If the Commission adopts its proposed prohibition against RIAs trading crypto assets on centralized platforms, the immediate outcome will be to deprive RIAs of the deepest and most liquid venues for trading these assets. In the absence of these trading venues, RIAs will find it exponentially more difficult to fulfill their duty of best execution, thus harming RIA clients, whose trades cannot be optimally executed. Nor can RIAs simply delegate trading on platforms to broker-dealers, for, as the Commission acknowledges, there are no special-purpose broker-dealers who can both custody and trade crypto assets. The likeliest effect of the Safeguarding Rule’s proposed prohibition is therefore to effectively cut RIAs holding crypto assets off from many of the best and safest trading venues. This outcome will be most keenly felt by RIA clients who either will not be able to acquire or dispose of their crypto assets, or must do so in transactions that may not represent the best qualitative execution.

The RIAs charged with undertaking crypto transactions must thus choose between risking a violation of the fiduciary duty of best execution, or commit themselves to violating the prohibitions of the Safeguarding Rule. The Commission ought not place RIAs in this dilemma.

38 Id. at 33675.
39 Id.
40 Id.
41 Regulation Best Execution, 88 Fed. Reg. 5440, 5518 (Jan. 27, 2022)
B. The Commission Violates Applicable Law by Not Evaluating the Economic Implications of the Proposed Prohibition

The Commission’s own Office of General Counsel notes that “as SEC chairmen have informed Congress since at least the early 1980s—and as rulemaking releases since that time reflect—the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules.” However, the Commission gives no indication of having considered the many likely and adverse economic implications of its proposed prohibition on RIAs trading crypto assets on centralized platforms.

The Commission does not acknowledge, for example, that in the absence of centralized trading platforms, RIAs trading crypto assets will likely have to purchase the services of market makers by paying significantly higher fees — fees that would ultimately be borne by RIA clients. Elsewhere in the proposed Rule, the Commission notes the impact of negotiating power on transaction outcomes, but it fails to recognize, in this context, that smaller RIAs, or RIAs with lower trading volumes will likely be worst affected by higher market maker transaction fees, and will be powerless to negotiate lower fees. The Commission also does not acknowledge that centralized trading platforms provide significant advantages not just in terms of liquidity, but also in terms of anonymity, and the ability to split larger orders into smaller components, thereby often saving on transaction costs.

\[^{42}\text{SEC Memorandum at 3.}\]
\[^{43}\text{88 Fed. Reg. at 14,694.}\]
\[^{44}\text{Disclosure of Order Handling Information, 88 Fed. Reg. 58,338, at 58,345 (Jan. 18, 2019). “In today’s electronic markets, broker-dealers commonly handle such orders by using sophisticated institutional order execution algorithms and smart order routing systems that decide the timing, pricing, and quantity of orders routed to a number of various trading centers, and that may divide a large “parent” order into many smaller “child” orders, and route the child orders over time to different trading centers in accordance with a particular strategy.”}\]

The Commission makes no effort to assess the availability of liquidity for crypto assets on venues other than centralized platforms. The Commission asks whether the prohibition on trading crypto assets should apply to decentralized exchanges ("DEXs"), but does not survey whether, and to what extent RIAs use DEXs. The Commission makes no attempt to determine how much more it will cost the average RIA to transact with market makers instead of trading through centralized platforms. Nor does the Commission ask whether the prohibition will ultimately concentrate massive power in the hands of a few crypto asset market makers.

These significant omissions by the Commission, and its failures to collect and analyze relevant data relating to crypto asset markets and market makers, militate against the Commission's own stated best practice, which requires it to consider the economic implications of a rule. More seriously, these failures likely violate the Advisers Act's injunction to the Commission to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.45 These omissions and failures also add to the proposed Rule's vulnerability under the Administrative Procedure Act, which the D.C. Circuit Court of Appeals has interpreted as imposing on the Commission a "statutory obligation to determine as best it can the economic implications of the rule."46

Perhaps the Commission will ultimately be unable to meaningfully assess the costs and benefits of the proposed prohibition on platform-based trading of crypto assets, but it has not even made a rudimentary attempt to do so in the proposed Safeguarding Rule. This omission is likely a violation of the Administrative Procedure Act. As the D.C. Circuit Court of Appeals put it, "Uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself — and hence the

46 Chamber of Commerce v. SEC, 412 F.3d 133, 143 (D.C. Cir. 2005).
public and the Congress — of the economic consequences of a proposed regulation before it decides whether to adopt the measure.”

To ensure that the proposed prohibition on platform-based trading of crypto assets does not harm smaller RIAs, and RIA clients, and unduly concentrate power in the hands of a few market makers, the Commission should instead consider some minor changes to the Safeguarding Rule. We do not disagree with the Commission that RIAs must not trade crypto assets in a manner that renders them likely to misappropriation, but we question the Commission’s conclusion that all crypto asset trading platforms must be treated as being equally vulnerable to such misappropriation. Many crypto asset trading platforms have now put in place measures against the theft or loss of assets and anti-manipulation practices – the Commission should study these measures and permit RIAs to trade crypto assets on platforms that meet required security parameters such as robust wallet security (i.e., key generation & storage), insurance, periodic security audits, and bug bounty programs.

The Commission should also clarify that RIAs are permitted to trade crypto assets on DEXs. Unlike centralized exchanges, DEXs operate on a peer-to-peer basis, permitting crypto asset traders to transact directly without moving custody of their funds to the platform or other intermediary. Transactions on DEXs are instead facilitated through the use of smart contracts, i.e., self-executing agreements written in code. DEXs thus permit users to trade directly from

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47 Id. at 144.
their wallets by interacting with the smart contracts behind the trading platform. Traders are solely responsible for their funds and private keys, and DEXs bear no liability for these assets.\(^{50}\)

These distinctions between DEXs and centralized crypto trading platforms go to the heart of the Safeguarding Rule – if no transfer of custody of crypto assets is ever involved, the threat of misappropriation diminishes. Accordingly, we would urge the Commission to provide much-needed clarity by expressly stating that RIAs may trade crypto assets on DEXs without falling afoul of the Safeguarding Rule.

### III The Commission Should Re-Propose the Safeguarding Rule as It Relates to RIAs Holding Crypto Assets and Crypto Asset Custodians

In the Proposal’s very brief examination of the crypto asset markets, the Commission notes, among other things, that:\(^{51}\)

- market capitalization for crypto assets experienced a rapid growth from $1 billion in 2018 to $1 trillion in 2021;
- 16 percent of U.S. adults say they personally have invested in, traded, or otherwise used “cryptocurrencies”; and
- of the 50 largest investment advisers, 21 are offering or planning on offering some services related to digital assets.

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\(^{50}\) *Id.* See *also*, What is a DEX (Decentralized Exchange), (Jan. 23, 2023), available at https://chain.link/education-hub/what-is-decentralized-exchange-dex.

\(^{51}\) 88 Fed. Reg. at 14,739.
These statistics point to a market of remarkable growth and reach among retail and institutional investors alike. Yet, crypto assets, crypto asset markets, and RIAs dealing with them appear to be an afterthought to the Safeguarding Rule. The Commission collects and surveys practically no data on the crypto asset markets and RIAs who participate in them. The Commission conducts no cost benefit analyses with respect to the impact of the proposed Rule’s requirements on crypto assets. The Commission makes virtually no concession, and admits no nuance or exception to the proposed Rule to accommodate the unique features of crypto assets. The Commission entirely ignores the fact that rights associated with many crypto assets cannot be exercised except by moving them out of custody — a challenge that is not faced by traditional securities, and RIAs that transact in traditional securities. In the rare instance where the Commission specifically considers the crypto markets, it is only to propose an over-broad and unworkable restriction — a blanket ban on RIAs trading crypto assets on platforms.

The Commission’s approach, seemingly silent on almost all things crypto, cannot inspire confidence. It is by now horn-book law that where a regulatory agency “entirely [fails] to consider an important aspect of the problem,” it acts arbitrarily and capriciously, and in violation of the Administrative Procedure Act. We urge the Commission to place the proposed Safeguarding Rule on a sounder legal footing by reproposing the Rule in a manner that considers crypto assets, crypto asset markets and market participants on their own terms, instead of merely reflexively extending the proposed Rule as it applies to traditional securities.

CONCLUSION

a16z appreciates the opportunity to share its perspective on the Commission’s proposed Safeguarding Rule. Unfortunately, the proposed Rule appears to have largely failed to consider the logistics of how custody works for many crypto assets, the economics underpinning crypto asset markets, and even the basic statistics and other data that should inform a considered

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regulatory approach to RIA custody of crypto assets. As a result, RIAs holding crypto assets for their clients would likely find it almost impossible to implement the Safeguarding Rule in its proposed form.

We therefore ask that the Commission repropose the Safeguarding Rule as it relates to crypto assets, and that as part of such reproposal, the Commission:

- extend the proposed self-custodial exception to cover all assets for which no suitable qualified custodian can be reasonably found;
- permit RIAs to self-custody crypto assets if no qualified custodian can be reasonably found who will exercise the participatory rights associated with these assets in a safe and secure manner;
- remove the indemnification requirement; and
- clarify that RIAs may, without violating the Safeguarding Rule, trade crypto assets on DEXs, as well as on centralized exchanges that meet suitable security parameters such as the use of robust key generation and storage practices, the insurance of customer crypto assets, and the periodic SOC 2 audits.

We ask that, as part of the reproposal, the Commission first survey in significantly greater detail the qualified custodians who currently serve the crypto asset markets, and the range of crypto assets for which they provide custodial services. We suggest that the Commission use this, and other relevant data to undertake and publish detailed cost-benefit analyses evaluating the effects of the proposed Rule on crypto asset custodians, RIAs and markets. These cost-benefit analyses will help guard the proposed Rule against legal challenge — they are required under both the Administrative Procedure Act and the Advisers Act, and are in keeping with the Commission’s stated best practices.
The Commission notes in the Proposal that many RIAs may be reluctant to provide a full range of advisory services to their clients with respect to crypto assets because of concerns that a market for custodial services to safeguard these assets has not yet fully developed. The Commission has the opportunity to remove that reluctance by creating a secure, yet flexible custodial regime that enables RIAs to make full and productive use of client crypto assets, and to serve the full spectrum of client interests in crypto assets. a16z stands ready to work with the Commission towards developing that custodial framework.

Respectfully submitted,

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