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# RESPONDING TO THE SEC STAFF ON THE CUSTODY OF DIGITAL ASSETS UNDER THE 1940 ACT

*Several years ago, the SEC staff requested feedback on whether a registered fund investing in digital assets could satisfy the 1940 Act's custody requirements. In this article, the author suggests a response to the SEC staff's custody question that draws heavily from SEC rules and SEC staff no-action letters.*

By Susan Gault-Brown *

On January 18, 2018, the then-Director of the Division of Investment Management at the Securities and Exchange Commission ("SEC") sent a letter to two major asset management industry trade groups, the Investment Company Institute and the Asset Management Group of the Securities Industry Financial Markets Association, entitled: "Engaging on Fund Innovation and Cryptocurrency-related Holdings."[1] In this letter, the SEC staff invited the industry groups and any interested registered fund sponsors to engage with the staff on a number of issues under the Investment Company Act of 1940 implicated by the holding of digital assets by registered funds. Among these issues was custody, specifically how a registered fund investing in digital assets could "satisfy the custody requirements of the 1940 Act and relevant rules?"

In addition to posing questions, the letter also asked the industry to discontinue all registrations of registered funds seeking to invest in digital assets, stating that "[u]ntil the questions identified above can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products, and we have asked sponsors that have registration statements filed for such products to withdraw them."

This has essentially been the state of play since the 2018 letter was issued. The issues raised in the letter – including the issue of how the holding of digital assets by a registered fund could comply with the 1940 Act's custody requirements – have not yet been, at least in the SEC staff's view, "addressed satisfactorily."

This article provides a deeper dive into the SEC staff's custody question, asking whether there is a path to compliance under the current custody provisions of

[1] Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), *available at* https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm. *See* related letters dealing with custody of digital assets under the Investment Advisers Act of 1940: Engaging on Non-DVP Custodial Practices and Digital Assets (March 12, 2019), *available at* https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206; Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), *available at* https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

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the 1940 Act and the rules and guidance thereunder, paying particular attention to (1) the 1940 Act self-custody rule, Rule 17f-2, (2) the 1940 Act rule governing the use by registered funds of securities depositories, Rule 17f-4, and (3) instances in which the SEC staff has provided no-action letter relief for assets that do not fit neatly within the custody requirements in either Rule 17f-2 or Rule 17f-4. This article ends with suggested factors that might be included in a response to the SEC staff's custody question, as well as additional issues and information to be considered.

## OWNERSHIP OF DIGITAL ASSETS: PRIVATE KEYS

The term "digital assets" (also sometimes referred to as digital currencies, cryptocurrencies, crypto, tokens, coins, virtual assets, virtual currencies) is not defined under the federal securities laws; however, the working definition that is currently used by the SEC and the SEC staff is "an asset that is issued and transferred using distributed ledger or blockchain technology."[2]

Ownership of a digital asset (which is essentially computer code) is currently thought to be synonymous with ownership of a private key (a string of numbers and letters), which is a cryptographic tool that grants access to the digital asset. Access to a private key means access to the corresponding digital asset. In this way, a private key is similar to a bearer instrument, such as a stock certificate in bearer form. Unlike such a stock certificate, however, a private key can exist in multiple iterations. As a result, even if a custodian were to hold a private key, other copies of that key could exist. For example, a person could write down the private key on multiple pieces of paper and only give one copy to a custodian. Further distinguishing a private key from a stock certificate, a private key – like uncertificated securities – can be dematerialized, existing online with no physical form. Or, the private key can be captured in material form, such as by writing it down on a piece of paper or keeping it in a cold storage device.[3]

In light of these characteristics of private keys, the remainder of this article explores whether digital assets can be custodied within the requirements of the current provisions of the 1940 Act and its rules.

## TWO PEOPLE WALK INTO A BANK: SELF-CUSTODY AND CERTIFICATED SECURITIES

The custody requirements that apply to most registered funds are found in Section 17(f) of the 1940 Act. Section 17(f)(1) – adopted in 1940 as part of the original 1940 Act – provides that:

> Every registered management company shall place and maintain its securities and similar investments in the custody of (A) certain banks; (B) certain national securities exchange members or (C) the fund itself, "but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors."

This provision was adopted at a time when virtually all securities were issued in certificated form and when securities ownership normally entailed physical possession of stock certificates.

In 1941, the SEC adopted Rule 17f-2 under the 1940 Act, which provides that a fund will be considered to self-custody investments, as permitted under Section 17(f)(1), if the fund maintains the investments in a bank under any arrangement that allows the directors, officers, employees, or agents of the fund to withdraw such investments at will. Given the importance to a fund manager of being able to access a fund's investments, this rule likely was essential to funds and fund managers

[2] *See, e.g.*, The SEC Staff's Framework for "Investment Contract" Analysis of Digital Assets (April 3, 2019), *available at* https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets.

[3] Cold storage is storage that is not connected to the internet. A common type of cold storage is a physical device that can connect to a computer, similar to a thumb drive.

when securities were still in certificate form. Rule 17f-2 requirements include the following:

1) *Safekeeping in a Bank, Bank Vault or Other Bank Depository*. Generally, all fund investments must be deposited in the safekeeping of, or in a vault or other depository maintained by, a bank.

2) *Physical Segregation of Assets*. Fund investments maintained by the bank must be physically segregated at all times from those of any other person.

3) *Access to the Investments Requires Two Authorized Persons Acting Jointly*. The fund's board must designate no more than five authorized persons for the fund and adopt a resolution permitting access to the fund's investments only by two or more authorized persons acting jointly.

4) *Sign-In and Sign-Out Procedures*. Any person depositing or withdrawing investments from the bank's depository or ordering their withdrawal and delivery from the safekeeping of the fund must sign a notation that contains the following:

   (A) the date and time of the deposit, withdrawal, or order;

   (B) the title and amount of the securities or other investments deposited, withdrawn or ordered to be withdrawn, and an identification thereof by certificate numbers or otherwise;

   (C) the manner of acquisition of the securities or similar investments deposited or the purpose for which they have been withdrawn, ordered to be withdrawn; and

   (D) if withdrawn and delivered to another person, the name of such person.

5) *Auditor Verification Three Times Each Year*. Investments maintained by a fund must be verified by complete examination by an independent public accountant retained by the fund at least three times during the fiscal year, at least two of which shall be chosen by the accountant without prior notice to the fund. Under SEC Accounting Series Release No. 27, issued on December 11, 1941, the auditor's examination generally must entail a physical examination of the securities themselves.

Though dated, Rule 17f-2 and its requirements continue to apply to the self-custody of registered fund investments, whether or not in certificated form, unless other provisions of Section 17(f) and the rules thereunder apply.

## DIGITAL ASSETS: IS IT POSSIBLE TO COMPLY WITH RULE 17F-2?

Can a registered fund comply with Rule 17f-2 with respect to digital assets? (Let's assume, for purposes of this analysis, that "banks," as that term is defined in Section 2(a)(5) of the 1940 Act,[4] are (a) able under relevant banking regulations to custody digital assets and (b) offer such services to registered funds.[5]).

1) *Can a Registered Fund Comply with the Safekeeping by a Bank, Bank Vault, or Other Bank Depository Requirement?* Provided a registered fund's private key(s) are maintained in physical form, such as by using a cold storage device, and provided a registered fund has controls in place to ensure that no other copies of the private key(s) exist, the cold storage device could be maintained by a bank and could be placed in a bank vault or other bank depository. However, when the fund wishes to access a private key, for example, in order to trade a digital asset, Rule 17f-2 does not indicate how the bank would maintain the private key during this access time. If a bank is able to grant a fund manager access to a digital asset for trading, while at all times maintaining the private key with the bank, such a solution may satisfy Rule 17f-2.

[4] The 1940 Act definition of the term "bank" is "(A) a depository institution (as defined in section 1813 of title 12) or a branch or agency of a foreign bank (as such terms are defined in section 3101 of title 12), (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this subchapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph."

[5] This is quite an assumption, as currently, it is not clear that banks are permitted to custody digital assets, and it is far from clear that a digital asset custody service for registered funds is currently being offered by any banks. Bank regulatory issues are beyond the scope of this article.

2) *Can a Registered Fund Comply with the Physical Segregation of Assets Requirement?* Physical segregation of assets is achievable while private keys are in materialized form. However, again, when a fund manager wishes to access the digital assets, it is not clear that physically segregating a cold storage device that is connected to the internet (in order to access the corresponding digital assets) would satisfy physical segregation for purposes of the rule.

3) *Can a Registered Fund Comply with the Access by Two Authorized Persons Acting Jointly Requirement?* It seems that a registered fund could comply with this requirement.

4) *Can a Registered Fund Comply with the Sign-In and Sign-Out Procedures Requirement?* It seems that a registered fund could comply with this requirement.

5) *Can a Registered Fund Comply with the Auditor Verification Requirement?* A registered fund could comply with the auditor requirements of the rule, but it is not clear from either the rule or the related auditor guidance how an auditor would physically inspect the private keys, even if it materialized.

Based on the above analysis, even if a registered fund was willing to twist itself into knots (along with a willing bank) in an attempt to satisfy the requirements of Rule 17f-2, it seems likely that the results would be clunky and ultimately impractical as applied to digital assets.

## TOO MANY CERTIFICATES: THE MOVE AWAY FROM CERTIFICATED SECURITIES

Roughly 30 years after the adoption of Rule 17f-2, in 1970, after an unwieldy multitude of stock certificates led to the Paperwork Crisis[6] and the subsequent creation of the national clearance and settlement system that is used for most uncertificated securities, the 1940 Act was amended by adding Section 17(f)(2), which permits registered funds and their custodians to use "a system for the central handling of securities established by a national securities exchange or national securities association" for securities that "may be transferred or pledged by bookkeeping entry without physical delivery of such securities."

Pursuant to Section 17(f)(2), in 1978, the SEC adopted Rule 17f-4 to establish conditions for the use of U.S. securities depositories by registered funds. According to the SEC, Rule 17f-4 was intended to be compatible with the 1978 revisions to Article 8 of the Uniform Commercial Code ("UCC"), which applies to the ownership and transfer of investment securities under state law.[7] The 1978 version of Rule 17f-4 permitted securities to be deposited either by a registered fund directly or by the fund's custodian in "a (1) clearing agency registered with the Commission under Section 17A of the Securities Exchange Act of 1934, which acts as a securities depository, or (2) the book-entry system as provided in Subpart O of Treasury Circular No. 300, 31 CFR 306, Subpart B of 31 CFR Part 350, and the book-entry regulations of Federal agencies substantially in the form of subpart O."

With respect to the use of securities depositories by a registered fund's custodian, the 1978 version of Rule 17f-4 contained the following requirements:

1*). Segregation of assets*. Securities deposited in a securities depository had to be segregated in an account dedicated to the custodian's customer assets.

2*). Notice of transactions*. The custodian was required to send the registered fund a notice of any transfers to or from the depository account and maintain records of securities transferred to the account belonging to the registered fund.

3*). Internal accounting control reports*. The custodian was required to promptly send to the registered fund any internal accounting control reports received from the depository and send reports on the custodian's own systems of internal accounting control as the registered fund may request.

4*). Board oversight*. The registered fund's board was required to approve the arrangement and review it annually.

Rule 17f-4 was subsequently updated in 2003 to reflect the changes in custody practices that had taken

[6] The Paperwork Crisis is described in a speech by Larry E. Bergmann, Senior Associate Director of the SEC's Division of Market Regulation (the former name of the Division of Trading and Markets), *available at* https://www.sec.gov/news/speech/spch021004leb.htm, called "The U.S. view of the role of regulation in market efficiency."

[7] Final Rule: Custody of Investment Company Assets with a Securities Depository, Inv. Co. Act Rel. No. 25934 (Feb. 13, 2003) ("Rule 17f-4 Release"), *available at* https://www.sec.gov/rules/final/ic-25934.htm#P48_5663.

place since the rule was first adopted, as well as changes to UCC Article 8 adopted in 1994 relating to custody arrangements with securities depositories.[8] The 2003 version of Rule 17f-4 (which is the current version) liberalized the original conditions, and, importantly, broadens the concept of the types of depositories that may be used by a registered fund or its custodian under the rule.

With respect to a registered fund's custodian, as amended, the current version of Rule 17f-4 permits a fund's custodian to: "place and maintain financial assets, corresponding to the fund's security entitlements, with a securities depository or intermediary custodian" subject to the rule's conditions. As defined in the rule, "intermediate custodian" means "any sub-custodian that is a securities intermediary and is qualified to act as a custodian." The definition of a "securities intermediary" is provided in UCC Article 8-102(14) and includes "a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity." If we keep drilling down on these definitions, we find that the UCC definition of "securities account," found in UCC Article 8-501(a), means "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset."

Based on this string of definitions, it appears that the current version of Rule 17f-4 permits a registered fund's custodian to maintain the financial assets – a concept that is broader than securities (see UCC Article 8-102(9)) – of a registered fund with a sub-custodian bank acting as a securities intermediary. A clearing agency acting as a securities depository does not appear to be required.

Looking specifically at the requirements of the current version of Rule 17f-4 that apply to the use of a securities depository of an intermediary custodian by a fund's custodian, the rule requires: (1) the custodian and any intermediary custodian to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain such financial assets (the "due care" standard) and (2) the custodian to provide, promptly upon request by the fund, such reports as are available concerning the internal accounting controls and financial strength of the custodian.

With respect to the direct use of a securities depository by the fund, the rule requires: (1) the fund's contract with the securities depository or the securities depository's written rules for its participants, obligates the securities depository to exercise the due care standard and requires the securities depository to provide, promptly upon request by the fund, available reports concerning the internal accounting controls and financial strength of the securities depository and (2) the fund must have implemented internal control systems reasonably designed to prevent unauthorized officer's instructions.

## DIGITAL ASSETS: IS IT POSSIBLE TO COMPLY WITH THE CURRENT VERSION OF RULE 17F-4?

The 2003 revisions to Rule 17f-4 appear to create a potential path forward regarding the custody of digital assets – using an intermediary custodian as a depository for digital assets. However, it is not clear what this means in practice when applied to private keys. Further, the context surrounding Rule 17f-4 and its revision appears to urge caution to any registered fund trying to rely on its provisions with respect to digital assets. First, the SEC's adopting release for the revisions to Rule 17f-4 did not address the rule's apparent license to use intermediary custodians as depositories. Second, the adopting release specifically states that the liberalizing updates to Rule 17f-4 were a recognition that the SEC's "experience with depositories . . . has shown that the use of depositories raises substantially fewer risks than had been apparent in 1978."[9] It is unlikely that the SEC's experience with securities depositories informs its views or experience with respect to the custody of digital assets. As a result, absent SEC or SEC staff guidance, it is unlikely that a registered fund seeking to invest in digital assets could comply with 1940 Act custody requirements through reliance on the current version of Rule 17f-4.

## SEC STAFF NO-ACTION RELIEF UNDER RULE 17F-2

In the past, in the context of assets that do not lend themselves to easy reliance on either Rule 17f-2 or Rule 17f-4, the SEC staff has provided no-action relief. Specifically, the SEC staff has provided relief under Rule 17f-2 in circumstances involving uncertificated investments not held by securities depositories. In these letters, relief was conditioned on requirements designed

[8] Rule 17f-4 Release.

[9] Rule 17f-4 Release.

to adapt the requirements of the 1978 Rule 17f-4 to investments at issue.

The most recent of these no-action letters is K&L Gates LLP,[10] in which the SEC staff provided relief with respect to certain loan interests that were not represented by any securities certificate or other tangible evidence of ownership that could be custodied with a fund's custodian. If endorsed and delivered to a subsequent purchaser or other third party, the loan interests could not be used by the third party to evidence its own right to the loan interests. The loan interests typically were reflected on the records maintained by the administrative agent for the relevant loan. The administrative agent for a loan was responsible for administering the loan on behalf of the relevant lending syndicate. The agent typically was one or more of the primary loan lenders or another financial institution.

In providing relief, the SEC staff imposed several conditions that appeared to look to the administrative agent as a reliable recordkeeper of the funds' interests: (1) the loan interests must be titled or recorded at the administrative agents in the name of the fund and not in the name of the fund manager; (2) settled loan interests must be reconciled to the records of the administrative agents on a regular basis; and (3) the administrative agents must be unaffiliated with the fund and fund manager (the Administrative Agent Conditions).

Similarly, in a much earlier no-action letter, Gardner Fund,[11] the SEC staff provided relief under Rule 17f-2 to a fund-of-funds, allowing it to maintain its investments in underlying funds in the book-entry systems of the underlying funds' transfer agents. Several of the conditions for relief focused on the role of the underlying funds' transfer agents: (1) the underlying funds' transfer agents must send confirmation of each transaction to the fund-of-funds and (2) the fund-of-funds' internal accounting controls must subject all confirmations from the underlying funds' transfer agents to daily proof against the transaction authorizations of the fund-of funds (the Transfer Agent Conditions).

Other conditions of these letters focus on the registered fund itself, including the following: (1) fund personnel involved in confirmations and reconciliations of fund transactions cannot be investment management personnel or personnel involved in transmitting investment instructions; (2) only a limited number of authorized personnel of the fund are permitted to provide instructions to the administrative agents or transfer agents (as applicable); (3) passwords or other appropriate security procedures would be used to ensure that only properly authorized persons can transmit such instructions; and (4) a fund must adopt policies and procedures under Rule 38a-1 of the 1940 Act reasonably designed to prevent violations of the custody conditions (the Fund Conditions).

Each letter also addressed the audit requirements under Rule 17f-2. In the case of the K&L Gates letter, the staff did not require compliance with Rule 17f-2 audit requirements, including its requirements for three audits each year, based in part on the fact that fund managers are required to comply with the annual audit requirements under the custody rule of the Investment Advisers Act (Rule 206(4)-2). The Gardner letter provided the following audit relief: the fund-of-funds auditor was permitted to conduct reconciliations of the fund-of-funds' records of securities held with the confirmation and account statements of the underlying funds and, in appropriate cases, to independently confirm the fund-of-funds' records of its holdings of such securities with the records maintained by the underlying funds.

## DIGITAL ASSETS: TAKEAWAYS FROM THE SEC STAFF'S NO-ACTION LETTERS

A registered fund seeking to invest in digital assets likely could not rely on the above staff letters – in particular, unlike the assets at issue in the letters, possession of a private key by a third party *would* evidence the third-party's right to the corresponding digital assets. This potential was not an issue in the staff letters. Even if we put this difference aside, it would be challenging for a registered fund to comply with the conditions in the staff letters, particularly the Administrative Agent Conditions/Transfer Agent Conditions. In the digital asset context, the most obvious entity to fill the role of the administrative agents (in the case of the loan interests) or the transfer agents (in the case of interests in underlying funds) is the blockchain itself.

However, it is doubtful (not from a technological perspective, but from a regulatory perspective) that the SEC or SEC staff would allow a blockchain to serve in this role. This is clear in looking at the handful of registered funds that have registered their securities as digital securities. In this context, the SEC staff have not yet been willing to look to the blockchain as an official

[10] K&L Gates LLP, Jan. 13, 2021.

[11] Gardner Fund, Mar. 7, 1988.

recordkeeper.[12] The SEC staff has looked instead to each fund's transfer agent as the official books and records of each fund. The most recent disclosure describing the current arrangement is as follows:

> the Fund's transfer agent (. . . "Transfer Agent"), will maintain the official record of share ownership in book-entry form (the "Official Record"), the ownership of the Fund's shares will also be recorded – or digitized – on one or more blockchains (the "Secondary Record"). The Transfer Agent will reconcile secondary blockchain transactions with the Fund's records on at least a daily basis. Reconciliation involves maintaining a matching Official Record and Secondary Record of the total number of shares in circulation, the ownership of the shares at any given time, and all transactions between parties involving the shares. The policies and procedures of the Fund and the Transfer Agent both address the use of blockchain integrated recordkeeping systems. The Fund's Board of Trustees has approved these policies and procedures, including those that address the use of blockchain integrated recordkeeping systems.[13]

If we think of this in the context of registered funds holding (rather than issuing) digital assets, it seems possible that the fund's transfer agent could serve in the role envisioned by the SEC staff no-action letters discussed above. If a transfer agent can serve in this custodial role – as in the Gardner letter – perhaps it would be possible to craft a custodial solution centering on a transfer agent rather than, or as an alternative to, a bank.

Arguably, permitting a registered fund to use an SEC-registered transfer agent as a custodian for digital assets would provide the SEC with greater control over the custodial practices to be used with respect to digital assets than the SEC would have with respect to a bank subject to regulation by a banking regulator. Such a move could also mesh well with SEC efforts to modernize transfer agent regulation.[14]

## RESPONDING TO THE SEC STAFF

Based on the rules and SEC staff no-action letters discussed above, one way to form a response to the SEC staff's question of how can a registered fund investing in digital assets comply with the 1940 Act's custody requirements is to build upon the requirements listed above. For example, a response might state that with respect to digital assets a fund would comply with Rule 17f-2(a), but in lieu of complying with the rest of the rule, the fund would comply with the following conditions drawn from a combination of the 1978 version of Rule 17f-4, the current version of Rule 17f-4, and the K&L Gates and Gardner no-action letters:

- The fund will comply with respect to its digital assets with all of the provisions in the current version of Rule 17f-4, except that the terms "securities depository" and "intermediary custodian" may include the fund's transfer agent, provided the transfer agent is unaffiliated with both the fund and the fund manager. (Compare to the provisions in the current version of Rule 17f-4 and a similar condition in the K&L Gates letter.)

- The fund's transfer agent must record each digital asset in the name of the fund and not in the name of the fund manager. (Compare to a similar condition in the K&L Gates letter.)

- The fund's transfer agent must send confirmation of each transaction to the fund's custodian or to the fund. (Compare to a similar condition in the Gardner letter.)

- All such confirmations must be reconciled by the fund's custodian or the fund against the fund's transaction authorizations (Compare to a similar condition in the Gardner letter.)

- The fund's transfer agent must reconcile its records of digital assets of the fund to the relevant blockchain daily and have the ability to "correct" the blockchain record through the use of subsequent transactions. (Compare to a somewhat similar condition in the K&L Gates letter.)

[12] Arca U.S. Treasury Fund, Franklin Onchain U.S. Government Money Fund, and WisdomTree Short-Term Treasury Digital Fund.

[13] WisdomTree Short-Term Treasury Digital Fund, Form N-1/A (Sept. 21, 2022), *available at* https://www.sec.gov/Archives/edgar/data/1859001/000121465922011368/wtd919226n1aa6.htm.

[14] *See, e.g.*, Transfer Agent Regulations, Advanced Notice of Proposed Rulemaking, Release No. 34-76743 (Dec. 22, 2015 *available at* https://www.sec.gov/rules/concept/2015/34-76743.pdf.

- Any fund personnel involved in confirmations and reconciliations of fund transactions cannot be investment management personnel or personnel involved in transmitting investment instructions. (Compare to similar conditions in the K&L Gates letter and Gardner letter).

- Only a limited number of authorized personnel of the fund are permitted to communicate with the fund's transfer agent regarding digital assets. (Compare to similar conditions in the K&L Gates letter and Gardner letter).

- Passwords or other appropriate security procedures must be used to ensure that only properly authorized persons can communicate with the transfer agent. (Compare to similar conditions in the K&L Gates letter and Gardner letter).

- The fund manager will comply with the audit requirements of Investment Adviser Act Rule 206(4)-2 as they apply to the fund.[15] (Compare to a similar condition in the K&L Gates letter.)

- The fund will adopt policies and procedures under Rule 38a-1 of the 1940 Act reasonably designed to prevent violations of these conditions. (Compare to a similar condition in the K&L Gates letter.)

In addition to the above requirements, other factors that may be relevant to a response include:

- The various proposed SEC cybersecurity rules and how they may apply to digital asset custody; and

- The 2022 updates to the UCC, particularly the addition of new Article 12, which applies to digital assets and particularly the concept of "control" with respect to digital assets.

Additionally, it is worth noting that several entities that currently provide digital asset custody services outside of the registered fund context have submitted public responses to the SEC staff's custody inquiries, each detailing the methods currently used to custody digital assets, focusing specifically on the safekeeping of private keys.[16] Information about actual methodologies that are used or are being developed by market participants is critical for supporting conditions like those listed above and crafting potentially better, more relevant conditions.

Any response to the SEC staff also must consider whether and how current digital asset custody methodologies support the policy goals and history of the 1940 Act custody requirements. And finally, any response must consider how such methodologies – which are still evolving – can be best captured in a no-action letter, exemptive order, or rule in a way that does not hinder further developments in digital assets or digital asset custody. ■

[15] We note that audit requirements with respect to digital assets under Rule 206(4)-2 are still being developed.

[16] *See, e.g.*, Separate responses from Coinbase, Anchorage, Prime Trust, and Fidelity Digital Asset Services, each *available at* https://www.sec.gov/investment/engaging-non-dvp-custodial-practices-and-digital-assets.