

December 15, 2022

Secretariat of the Financial Stability Board
Bank for International Settlements
CH-4002 Basel
Switzerland

Via e-mail: fsb@fsb.org

Consultative Document – Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets

Dear Sir/ Madam:

State Street Corporation (“State Street”) welcomes the opportunity to comment on the consultative document (“consultation”) issued by the Financial Stability Board (“FSB”) on the regulation, supervision and oversight of crypto-asset activities and markets (“crypto-asset system”). The consultation responds to a February 2022 request from finance ministers and central bank governors of the Group of Twenty for ‘coordinated and timely policy actions to preserve global financial stability’, and includes a series of high-level recommendations designed to strengthen the existing regulatory framework for the crypto-asset system and to help promote greater consistency of policy outcomes globally.¹ We strongly support the FSB’s work which we believe thoughtfully describes key deficiencies in the organization of core components of the existing crypto-asset system and offers simple yet effective recommendations for their remediation based on the essential policy principle of ‘same activity, same risk, same regulation’. This includes, in the case of the custody function, the proper segregation of client assets from proprietary assets, the functional separation of safekeeping operations from trading and other similar market activities, and the full and accurate disclosure of the terms and conditions of the services offered. Recognizing the importance of this work, we offer a number of technical suggestions to further strengthen the

¹ ‘Communique’, G-20 Finance Ministers and Central Bank Governors Meeting, Jakarta, Indonesia (February 17-18, 2022).

intended approach, focusing on key principles for the organization of the custody function, as well as disclosure standards and expectations for the management of third-party risk.

Headquartered in Boston, Massachusetts, State Street is a global custody bank which specializes in the provision of financial services for institutional investor clients, such as asset owners, asset managers and official sector institutions. This includes investment servicing, investment management, data and analytics, and investment research and trading. With \$35.68 trillion in assets under custody and administration and \$3.27 trillion in assets under management, State Street offers its clients the ability to transact and hold assets in more than 100 geographic markets globally.² State Street is organized as a United States (“US”) bank holding company, with operations conducted through several entities, primarily its wholly-owned state-chartered insured depository institution subsidiary, State Street Bank and Trust Company. While our primary prudential regulators are therefore the Massachusetts Division of Banks and the US Federal Reserve System, we are subject to oversight by numerous banking regulators in the various jurisdictions in which we operate.

The State Street organization includes State Street Digital, which was established to address the ongoing digital transformation of the financial system driven by emerging technologies such as blockchain, tokenization and smart contracts, and the resulting need to develop solutions to support our core business operations and our clients’ evolving interests across the investment life cycle. While market participants have, and continue to demonstrate, the transformative implications of new technologies in the provision of various financial products and services, the potential benefit of this innovation is today significantly impaired by the fractured and inconsistent manner in which the activities of the non-bank entities that dominate the crypto-asset system are regulated. This is compounded by the misuse, whether intentionally or unintentionally, of terminology that is common in the world of traditional finance to create the perception of rigor in the conduct of key functions that does not in fact exist. For instance, Acting Comptroller of the Currency Michael Hsu aptly noted in an October 2022 speech that while ‘customers know what they are getting when they ask a custodian bank to custody traditional assets....the same cannot be said of certain crypto custodians (including crypto-exchanges)... where user assets are (often) commingled directly with platform assets—a practice that would not be acceptable or deemed to constitute custody in traditional finance’.³

As a practical matter, this results in a regulatory and supervisory approach to the crypto-asset system that fails to adequately ensure key policy outcomes, such as the protection of the consumer, the promotion of safety and soundness, and the effective management of financial stability risk. The outcome of these limitations can be

² As of September 30, 2022.

³ ‘Skeuomorphism, Commingling, and Data Gaps in Crypto’, remarks by Acting Comptroller of the Currency Michael Hsu at DC Fin-tech Week 2022 (October 11, 2022).

severe as demonstrated by the recent collapse of FTX, a thinly regulated crypto-exchange operating a vertically integrated business model across a broad range of financial activities, including the custody of client assets, without proper regard for the effective management of risk.

Banking organizations are today the primary providers of custody services for traditional assets and their activities are governed by a robust set of prudential mandates designed to ensure that they operate in a safe and sound manner. This includes capital, liquidity, stress testing, counterparty credit risk monitoring and other financial resilience requirements, data security and investor protection mandates, cybersecurity and other operational systems and control expectations, and recovery and resolution planning obligations. To comply with these mandates, banks have implemented and operate robust risk management frameworks which address, among other matters, the monitoring and management of key financial metrics, information technology systems and controls, third-party risk management and the maintenance of anti-money laundering and other financial crimes enforcement infrastructure.

To ensure compliance with these expectations, banking organizations are subject to ongoing regulatory oversight and examiner review. Thus, the existing regulatory framework for banking organizations places risk-management at the forefront of the entity's activities, unlike for the non-bank entities that today dominate the crypto-asset system where the primary focus is on the maximization of profit. As such, banking organizations are well-positioned to help address and materially reduce existing risk within the crypto-asset system, and we welcome the opportunity to offer our views on the FSB's proposed recommendations as they relate to the organization and operation of the custody function.

Separation of Functions, Segregation of Assets and the Exercise of Proper Control

Custody banks, such as State Street, have a long history of providing safekeeping services for their clients on the basis of a clearly established body of law and regulation that defines and supports the client's ownership rights over assets held in custody. For example, Article 8-503(a) of the US Uniform Commercial Code ("UCC") provides that financial assets held by a securities intermediary (i.e. a custodian) for a client (i.e. the entitlement holder) are not property of the securities intermediary and are not subject to claims of creditors of the securities intermediary. Furthermore, Article 8-102(9) of the UCC specifies that a 'financial asset' includes any property that is held by a securities intermediary (i.e. a custodian) for another person in a 'securities account', if the parties have expressly agreed that the property is to be treated as a financial asset under Article 8.

To comply with these mandates, banking industry practice for the safekeeping of client assets incorporates three core principles which are designed to effectively manage the potential risk of misappropriation or loss. These principles, which apply to any asset held in custody, can be summarized as follows:

- Separation of Financial Activities: safekeeping operations must be functionally separated from trading and other similar market activities;
- Segregation of Client Assets: client assets must be segregated at all times from the bank's proprietary assets to ensure that they are bankruptcy remote;
- Proper Control: the custodian must maintain proper control over client assets in order to identify the entitlement holder and to mitigate any 'single point of failure' in the record of ownership.

In Section 3.4 of the consultation on 'Risk Management Related to Wallets and Custody Services', the FSB notes that the failure to 'properly segregate' crypto-assets 'from the provider's own liabilities' may expose the client to 'investment losses in the event the provider is insolvent or otherwise fails to uphold its obligations.'⁴ In response, the FSB recommends in Section 4.3 of the consultation on 'Proposed Recommendations for Risk Management' that 'authorities should supervise and regulate custodial wallet service providers....in order to address...risk that may arise from the storage of the customer's private keys' and should 'assess the adequate safeguarding of customer assets....for example through segregation requirements.'⁵

In turn, in Section 3.7 of the consultation on the 'Combination of Multiple Functions within a Single Service Provider', the FSB notes that the entities that currently dominate the crypto-asset system resemble financial conglomerates that vertically integrate multiple functions within a single entity, and that it may, in this respect, be 'appropriate (for regulatory authorities) to disallow the provision of certain combinations of services or functions by a single entity'.⁶ This is followed in Section 4.3 of the consultation on 'Proposed Recommendations for Crypto-Asset Service Providers with Multiple Functions' by the observation that regulatory authorities should 'ensure that crypto-asset service providers that combine multiple functions and activities....are subject to appropriate regulation, supervision and oversight...including requirements regarding the separation of certain functions and activities'.⁷

⁴ FSB Consultation, page 13.

⁵ FSB Consultation, page 22.

⁶ FSB Consultation, page 15.

⁷ FSB Consultation, page 24-25.

Informed by our 80+ years of experience in safely supporting client assets in an increasingly complex global financial marketplace, we strongly support the FSB's dual recommendations. The segregation of client assets is the fundamental basis upon which the custody function is organized and applies irrespective of the asset type, system of record or location of the asset. Indeed, custody banks have historically adapted to the evolution of the financial markets and their clients' investment interests to custody many different types of assets in many geographic locations, whether in the form of paper certificates held in a vault, to 'book entry' records held in a computer database, to tokenized assets held on a blockchain. As such, there is no valid reason why the segregation of client assets should not apply to custody providers in the crypto-asset system, even if the underlying technology and operational solution may differ. We recommend, however, that the FSB strengthen the expectations which apply to the providers of custody services in the crypto-asset system by affirming that regulatory authorities should 'ensure' the segregation of client assets from proprietary assets at all times rather than simply 'assessing' whether such a condition is necessary.

Policymakers have long understood that there are important differences in the risk profile of various financial activities and that these risks can be aggravated when discrete functions are inappropriately commingled and operated within a single entity. This is especially true where there is a strong incentive for the entity to maximize its profits and where that activity may result in economic harm to the client, such as the loss of its assets. As a result, there is a well-established body of law and regulation that requires various financial activities and functions to be separated among discrete entities. This includes, in particular, the separation of the custody function, which involves the safeguarding of client assets, from trading and investment activities. For instance, European Union law requires the assets of regulated investment funds (i.e. Undertakings for Collective Investments in Transferable Securities) to be held by a depositary bank responsible for both the safekeeping and oversight of fund assets. Similarly, Section 17(f) of the US Investment Company Act requires management companies of mutual funds to maintain the fund's securities and similar investments in the custody of an entity subject to regulation that is necessary for the protection of investors, including via the segregation of assets.

These requirements are widespread across the global financial industry and are intended to protect the consumer from harm. There is, as such, no compelling reason why similar mandates should not apply to the provision of custody services for crypto-assets. Indeed, given the nascency of the crypto-asset system, the rapidly evolving technology underlying crypto-assets and the inherent focus of blockchain technology on the disintermediation of market participants, it can persuasively be argued that there is an even more compelling need for regulators to mandate the functional separation of custody operations from trading and other similar market activities. While the consultation's approach to vertically integrated entities in the crypto-asset system is broadly aligned with this perspective, we believe that it would be helpful for the FSB to clarify its expectations by directly affirming that the

custody function must be functionally separated from the other financial activities of exchanges and other platform entities that operate in this space today.

In order to further mitigate potential financial stability risk, we also suggest that the FSB add to its recommendations that regulatory authorities should require providers of custody services in the crypto-asset system to maintain proper control over client assets in order to both identify the entitlement holder and mitigate any 'single point of failure' in the record of ownership. The critical element of exercising control over crypto-assets is the management of the private keys underlying the asset. While solutions are likely to evolve over time with advancements in technology, in the current environment, this can be achieved via the use of multi-party computation and other similar technologies to create multiple 'shards' of the same private key, so that no single party can authorize the transfer or other disposition of the asset. Furthermore, to the extent that a shard is lost, stolen or rendered inoperable, the remaining shards can support retrieval of the crypto-asset into a new custody wallet with a new set of private keys and related shards. Regardless of the solution deployed, the principle of proper control is crucial to the organization of the custody function and therefore appropriate for the FSB to include in its recommendations for the regulation and supervision of the crypto-asset system even while avoiding prescriptive standards that may inadvertently constrain technological innovation.

Client Disclosure and Other Matters

In Section 4.3 of the consultation on 'Proposed Recommendations for Disclosures', the FSB states that 'authorities should require the service provider to provide a full and accurate disclosure to any client for whom it is providing custody services of the terms and conditions of the custodial relationship and the risks that could be faced by the client if the custodian were to enter into bankruptcy'.⁸ We strongly support this approach, which is foundational to the proper undertaking of any financial relationship. Indeed, the starting point of the relationship between a custody bank and its institutional investor client is a negotiated contract that carefully sets out the scope of the services to be provided, key terms and conditions relevant to those services, the standard of care that the custody bank will exercise in carrying out its duties and the governing law of the contract.

Furthermore, the contract establishes the conditions under which client assets will be held in safekeeping, including the segregation of client assets from proprietary assets, and affirms that assets held in custody belong to the client, not the custodian. We believe that a similar approach should be used when custody services are provided by any entity in the crypto-asset system, supported to the extent necessary by additional prominent

⁸ FSB Consultation, page 23.

disclosures for those investors (primarily retail) that may lack the necessary sophistication to fully understand the underlying risk, in a manner consistent with the requirements that apply today for retail investors in regulated collective investment funds.

In Section 4.3 of the consultation on 'Proposed Recommendations for Risk Management', the FSB helpfully emphasizes that 'authorities should require crypto-asset service providers to have an effective risk management framework in place that addresses all material risks associated with their activities'.⁹ It then goes on to emphasize certain components of such a framework, including the assessment of technology risk, the establishment of contingency arrangements and effective business continuity planning. While we strongly endorse these recommendations, we believe that they could be further strengthened by adding the obligation for crypto-asset service providers to carefully consider and manage third-party risk. This reflects the existing structure of the crypto-asset system where large numbers of entities are aggressively competing to develop and deploy novel solutions for various products and services, creating links with established market participants that must be carefully identified and risk managed. In the current environment, the appropriate assessment of third-parties in the crypto-asset system can be challenging for banking organizations to undertake, a circumstance that could be improved through clearer guidance from regulatory authorities on their expectations for all service providers in the market.

Conclusion

Thank you once again for the opportunity to comment on the important matters raised within the consultation. To summarize, we welcome and strongly support the FSB's recommendations for the regulation, supervision and oversight of the crypto-asset system and offer a series of targeted suggestions to improve the intended approach, focusing on the organization of the custody function. This includes the more affirmative adoption of the three core principles for the custody of assets (separation of financial activities, segregation of client assets, proper control), as well as the use of contracts to ensure the proper disclosure of the terms and conditions of the custody services provided and the setting of consistent expectations for the management of third-party risk.

⁹ FSB Consultation, pages 21-22.

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Please feel free to contact me at jjbarry@statestreet.com should you wish to discuss the contents of this submission in greater detail. We welcome the opportunity to further engage with the FSB on these matters and we stand ready to provide whatever assistance may be appropriate.

Sincerely,

A handwritten signature in black ink, appearing to read "JJ Barry", with a stylized flourish at the end.

Joseph J. Barry