STATE STREET.

State Street Corporation

Joseph J. Barry
Senior Vice President and Global Head of
Regulatory, Industry and Government Affairs

State Street Financial Center
One Lincoln Street
Boston, MA 02111-2900

Telephone: 617.664.1254
E-mail: jjbarry@statestreet.com
www.statestreet.com

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Ms. Natalia Li
Deputy Director
Office of Financial Institutions Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Via electronic submission: www.regulations.gov

Request for Comment – Ensuring Responsible Development of Digital Assets

Dear Ms. Li:

State Street Corporation ("State Street") welcomes the opportunity to respond to the request for comment ("RFC") issued by the Department of the Treasury ("Treasury") regarding the implications of the development and adoption of digital assets and related changes to the financial markets and payment infrastructure ("financial markets") of the United States ("US") for consumers, investors and businesses, including for those citizens who are most vulnerable to economic insecurity ("US public"). The RFC responds to Executive Order 14067 ("Executive Order") on 'Ensuring Responsible Development of Digital Assets', issued on March 14, 2022, which outlines the policy objectives of the administration with respect to digital assets. Among these objectives are the protection of the US public, the promotion of financial stability and the mitigation of systemic risk. In response, the Treasury emphasizes in the RFC the need for policy measures that 'ensure that digital assets do not pose undue risks', while also requesting feedback on 'potential mitigation factors' to such risks.[1]

We strongly support the 'whole of government' approach to the development of policy for digital assets reflected in the RFC, and we believe that the potential risks faced by the US public and the financial markets can best be supported by policy solutions that (i) recognize the

[1] Request for Comment, Section III (C) (4), Federal Register, Volume 87, Number 130 (July 8, 2022), page 40882.

important role that the banking industry can plan in promoting responsible innovation and (ii) address pressing shortcomings in the regulation of the non-bank entities that currently dominate the digital financial ecosystem through the application of the core principle of 'same activity, same risk, same regulation.'

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 pension plans and mutual funds, that support the accumulation of retirement savings and other sources of personal wealth. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $38.2 trillion in assets under custody and administration and $3.5 trillion in assets under management, State Street offers its clients the ability to transact in more than 100 geographic markets globally.[2] State Street is organized as a US bank holding company, with operations conducted through several entities, primarily its wholly-owned Massachusetts-state chartered insured depository institution subsidiary, State Street Bank and Trust Company.

The State Street organization includes State Street Digital, which was established to address the rapid evolution of the financial system and the resulting needs of our clients across the entire investment life cycle. The ongoing digital transformation of the financial system, driven by emerging technologies such as tokenization, blockchain and artificial intelligence, is real and will result over time in access to new investment solutions that enhance transparency and the ability to manage risk, while also driving improvements in the efficiency of the financial markets, with important benefits for long-term investors. In Section C of the RFC, the Treasury requests input on 'risk arising from current market conditions in digital assets and any potential mitigating factors', including with respect to 'settlement and custody.'[3]

We welcome the opportunity to offer our thoughts on ways to support responsible innovation in the digital financial ecosystem, informed by our role as a global custody bank, a role that is widely understood by market participants and by the regulatory community as providing important benefits for the safety of assets and the stability of the financial system. Modern custody services have been offered by the US banking industry for 80+ years, with significant success, and global custody banks such as State Street, have adapted to the evolution of the financial markets to safely custody many different types of assets, from paper certificates held in a vault, to 'book entry' records in a computer database, to tokenized assets held in a distributed ledger system or other similar application.

The broad and value-added role played by the US financial services industry today is underpinned by the strength of the US regulatory framework. For instance, the manner in which US custody banks organize and operate their safekeeping and asset administration services functions is heavily influenced by Section 17(f) of the Investment Company Act of 1940,

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[2] As of June 30, 2022.
[3] Request for Comment, Section III (C) (4), Federal Register, Volume 87, Number 130 (July 8, 2022), page 40882.

which is viewed as the 'gold standard' for custody, and which requires mutual funds to maintain their securities and similar investments with entities under conditions designed to maintain the safety of fund assets. Similarly, the services offered by US custody banks are also influenced by Rule 206(4)-2 of the Investment Advisors Act (*i.e.* the 'custody rule') which requires investment advisors that have custody of client assets to use a 'qualified custodian', such as a banking organization, to maintain those assets.

There are, in our view, two important steps which US policymakers should take to help address existing and potential risk that may result from the development of the digital financial asset ecosystem. They are as follows:

Promoting the Role of Banking Organizations

In order to help achieve the administration's policy objectives for digital assets, including the protection of the US public and the mitigation of potential financial stability risk, we believe that policymakers should actively encourage the participation of banking organizations in the promotion of responsible innovation.

Banking organizations are today subject to robust prudential mandates designed to ensure that all bank activities are conducted in a safe and sound manner. This includes capital, liquidity, stress testing, counterpart 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, counterparty due diligence, information technology systems and controls, third-party risk management and the maintenance of anti-money laundering and other financial crimes compliance infrastructure.

Furthermore, 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, and the integration of the digital financial asset ecosystem within this robust framework will help ensure that digital asset innovation is held to the same high standards. In contrast, any approach that substantially limits banking industry participation in the financial markets for digital assets will heighten the risks faced by the US public, while also narrowing the ability of policymakers to deploy solutions which support responsible innovation.

Regulators should, in our view, work collaboratively to define appropriate parameters for how the banking industry can deploy its considerable risk management expertise to help protect the US public and the integrity of the financial markets. Banks are institutions that have a long and productive history of offering financial services, using systems, controls and practices that are designed to properly manage key risks, notably the risk of loss or misappropriation of assets. Similarly, banks are also well-placed to drive the standardization of industry processes, over time, to improve efficiencies, promote the seamless integration of market structures and reduce operational risk as technology evolves. As such, regulators should logically seek to encourage that role, rather than relying on an approach that would narrow participation in the digital marketplace to those entities that are least equipped to manage the resulting risk.

Regulation of Non-Bank Entities

While it is clear that the US economy does not lack in the ability to innovate, including in the development of transformative technologies for the provision of financial services, the productive potential of this innovation is, in our view, significantly impaired today by the fractured and inconsistent manner in which the activities of non-bank entities in this space are regulated. As a practical matter, this is reflected in a regulatory approach for the digital financial ecosystem that is suboptimal, with insufficient regard for market stability, investor protection and the proper management of risk. This is also reflected in highly inconsistent standards for core structural components of the control environment for digital financial assets, such as the use and protection of client data, the deployment of anti-money laundering and other financial crimes controls and the mitigation of information technology and cyber-risk. One clear manifestation of this outcome are the repeated instances in which digital financial assets have recently been misappropriated from thinly regulated platform entities offering trading, safekeeping, lending and other services without the controls that apply to banking entities, in a manner that poses undue risk to the US public.

In order to overcome these limitations, we believe that the administration should work in close coordination with the agencies to appropriately define and consistently apply a robust set of regulatory standards for all non-bank entities operating in the digital financial marketplace based on the core principle of 'same activity, same risk, same regulation.' For instance and from our perspective as a custody bank, this would include the requirement for all providers of safekeeping services for digital assets to: (i) functionally separate trading and custody activities, (ii) deploy robust risk management systems, processes and controls that ensure the segregation of client assets from the providers own assets at all times, and (iii) exercise proper control over the private keys underlying the crypto-asset to ensure that there is no 'single point of failure'. Furthermore, non-bank providers of custody services should be subject to appropriate capital and liquidity requirements, operational resilience obligations, business continuity mandates and the implementation of robust data privacy and cybersecurity controls. Finally, non-bank providers of custody services should be subject to ongoing supervisory oversight and review.

Thank you once again for the opportunity to comment on the matters raised in the RFC relative to the development and adoption of digital assets in the US, including ways to help mitigate risk to the US public and promote the stability of the financial markets. To summarize, State Street welcomes the 'whole of government' approach adopted by the administration for the development of policy for digital assets, and we believe that existing and potential risks in the digital financial ecosystem can best be supported by: (i) recognizing the crucial role which the banking industry can play in the development of responsible innovation, and (ii) subjecting non-bank entities active in the digital financial ecosystem to a robust set of regulatory standards based on the core principle of 'same activity, same risk, same regulation.'

Please feel free to contact me at jjbarry@statestreet.com should you wish to discuss the contents of this submission in greater detail.

Sincerely,

Joseph J. Barry