May 8, 2023

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

Re: Safeguarding Advisory Client Assets (File No. S7-04-23, RIN 3235-AM32); 88 Fed. Reg. 14,672 (Mar. 9, 2023)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release")[2] of the Securities and Exchange Commission ("SEC" or "Commission"), which would enhance protections for client assets managed by registered investment advisers.

Since the custody rule was originally promulgated in 1962, the SEC has repeatedly revisited and amended its requirements relating to the safeguarding of client assets by registered investment advisers. The overarching goal has been and remains the same: "to safeguard client funds and securities from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated."[3]

For a host of reasons, it is now time once again to modernize the custody rule to better protect investors' assets from fraud or investment adviser insolvency. For example, updating the rule would address important trends in the capital markets by expanding its scope beyond funds or securities to encompass all assets, including crypto assets to the extent they are not already covered as funds or securities. In a related vein, the broader and more flexible concepts in the Proposal will help make custody obligations more adaptable in the future as the markets continue to evolve.

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Safeguarding Advisory Client Assets, 88 Fed. Reg. 14,672 (Mar. 9, 2023).

[3] Release at 14,673.

The Proposal is also grounded in experience, as it would help address threats to investor assets that are evident from many more recent examples of misappropriation, theft, hacks, bankruptcies, and other brazen fraudulent schemes. It also comports with Congress's desire to ensure that client assets are appropriately protected, as evidenced in the Dodd-Frank Act. And ultimately, as explained in the economic analysis accompanying the Proposal, these reforms will help promote investor confidence in advisory services, for the benefit of the capital markets more broadly.

The Proposal would further all of these goals by amending and redesignating Commission rule 206(4)-2 ("custody rule") under the Investment Advisers Act of 1940 as new rule 223-1 ("safeguarding rule") and making a number of important enhancements to ensure better protection of client assets managed by registered investment advisers. The principal reforms in the Proposal include these:

- First, the Proposal would expand the scope of assets subject to the custody rule to include not only client funds and securities but also all assets managed by advisers, including crypto assets and other positions held in the client's account.
- Second, the Proposal clarifies that discretionary authority over client assets meets the definition of custody.
- Third, the Proposal would strengthen the requirements for qualified custodians by requiring possession and control over client assets, defined in part to mean that qualified custodians must participate in any change in beneficial ownership of those assets, and it would further require written agreements between qualified custodians and advisers that provide for safeguards and internal controls.
- Fourth, the Proposal would modify the current rule's "privately offered securities" exception from the obligation to maintain client assets with a qualified custodian by expanding the exception to include certain physical assets. However, this exception, for both privately offered securities and physical assets, would be subject to the conditions that the adviser reasonably determines the assets cannot be custodied with a qualified custodian and that the adviser takes additional steps to ensure safeguarding.
- Fifth, the Proposal would require advisers who have custody to segregate client assets from other assets, including a duty to title or register those assets in the client's name.
- Finally, the Proposal would require advisers to maintain books and records relating to the safeguarding rule and conforming changes to Form ADV.

It is necessary and appropriate for the Commission to modernize its custody rule to ensure registered investment advisers are better safeguarding their client's funds, securities, and other assets from the risk of loss. The Proposal will advance that goal and we support it.

BACKGROUND

The U.S. capital markets are the broadest, deepest, most liquid markets in the world. Their success is due largely to the foundational securities laws passed nearly a century ago, coupled with the development of an extensive set of rules and the SEC's work in implementing and enforcing those laws and regulations. This framework helps underpin our thriving capital markets, which in

turn enables entrepreneurs to raise capital and establish productive businesses. The securities markets also enable countless American investors—often with the help of investment advisers—to achieve their life goals, including planning for a dignified retirement, sending their children to college, and fulfilling other dreams.

The SEC's oversight of our $100 trillion capital markets includes the regulation of a vast investment advice industry, including 15,000 registered investment advisers who advise 50 million investors.[4] A critical aspect of this securities regulatory framework is instilling and preserving investors' confidence that when they entrust their hard-earned money with an SEC-registered investment adviser, there are adequate safeguards in place to ensure those assets are not subject to misappropriation, loss, or theft.

As the registered investment advisory business has matured, it has become necessary for the Commission to supplement the protections in its securities regulatory framework with a specific rule related to safeguarding client assets. The Investment Advisers Act of 1940 granted the Commission the authority to make rules and regulations that are "necessary and appropriate" to exercise its functions and powers that are "reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[5] Under this authority, the Commission adopted Rule 206(4)-2 in 1962, also known as the "custody rule." The custody rule required investment advisers who custody client funds or securities to "maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment adviser."[6] That 1962 rule became a central feature of the securities regulatory framework.

In a long overdue action, the Commission decided to revisit its custody rule in 2003 in light of changes to custodial practices that had rendered parts of the rule outdated or inconsistent with

4 Release at 14,737.

5 15 U.S.C. § 80b-11 ("The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the functions and powers conferred upon the Commission elsewhere in this title, including rules and regulations de fining technical, trade, and other terms used in this title, except that the Commission may not define the term ''client'' for purposes of paragraphs (1) and (2) of section 206 to include an investor in a private fund managed by an investment adviser, if such private fund has entered into an advisory contract with such adviser. For the purposes of its rules or regulations the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters"); 15 U.S.C. § 80b-6 (It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly… to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative").

6 Adoption of Rule 206(4) under the Investment Advisers Act of 1940, 27 Fed. Reg. 2,149, 2,149 (Mar. 6, 1962).

"modern custodial practices."[7] The revamped rule introduced the idea of the "qualified custodian," a type of financial institution such as a bank, savings association, broker-dealer, or foreign financial institution that advisers use to custody client assets.[8] The 2003 custody rule required advisers who custody client funds and securities to secure them with qualified custodians that would hold the funds or securities in an account under the client's name or under the adviser's name as agent or trustee for the client.[9] Notably, the rule allowed investment advisers or their affiliates to serve as "qualified custodians."[10] Additionally, the 2003 custody rule defined the term "custody" for the first time as "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them" and included various examples of what constitutes custody.[11]

However, as we have seen again and again throughout history, the financial incentive to break the law is irresistible and ever-present, and it often emerges on a grand scale. In an emergency SEC filing in federal court in December 2008, the SEC revealed that Bernie Madoff had admitted to conducting a years-long Ponzi scheme through his investment adviser business, which had liabilities of "approximately $50 billion."[12] This would ultimately become the largest Ponzi scheme in U.S. history and would also highlight weaknesses in the existing custody rules for registered investment advisors that the SEC and Congress would later amend.

As Professor John Coffee pointed out in congressional testimony, there were two material weaknesses in the SEC's approach to custody that Bernie Madoff was able to exploit.[13] First, Bernie Madoff became a registered investment adviser in 2006 under the Investment Advisers Act and was thus required to use a qualified custodian for client assets.[14] However, under the 2003 custody rule, Bernie Madoff was allowed to use his own broker-dealer affiliate as his qualified custodian for his client's assets.[15] This, as Professor Coffee points out, violates "the first rule of common sense: [y]ou cannot be your own watchdog."[16] Second, the Commission adopted an exemptive rule from the requirements of the Sarbanes-Oxley Act of 2002 that required broker-

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[7] *See* Custody of Funds or Securities of Clients by Investment Advisers, 68 Fed. Reg. 56,692 (Oct. 1, 2003).

[8] 68 Fed. Reg. 56,692, 56,693.

[9] *Id.*

[10] 68 Fed. Reg. 56,692, 56,694.

[11] 68 Fed. Reg. 56,692, 56,701.

[12] *See* Complaint, SEC v. Bernard L. Madoff, 08-CV-10791 (S.D.N.Y. 2008). The total paper losses from the Madoff Ponzi scheme would later reach $64.8 billion. *See* Diana B. Henriques, *Bernard Madoff, Architect of Largest Ponzi Scheme in History, Is Dead at 82*, N.Y. TIMES, Apr.14, 2021, https://www.nytimes.com/2021/04/14/business/bernie-madoff-dead.html.

[13] *How the Securities Regulatory System Failed to Detect the Madoff Investment Securities Fraud, the Extent to Which Securities Insurance Will Assist Defrauded Victims, and the Need for Reform: Hearing Before the S. Comm. on Banking, Hous., and Urb. Aff.,* 111th Cong. 38 (2009) (statement of John C. Coffee, Adolf A. Berle Professor of Law, Columbia University Law School).

[14] *Id.*

[15] *Id*.

[16] *Id*.

dealers to use PCAOB-registered accountants.[17] That exemptive rule permitted privately-held broker-dealers, such as Madoff's affiliated firm, to use a non-PCAOB-registered accountant. These material weaknesses in the Commission's approach to the custody of client assets helped spur the Commission to revisit the 2003 custody rule and later prompted Congress to engage on the issue in the Dodd-Frank Act.

In response to Madoff's largest Ponzi scheme in U.S. history, coupled with several other enforcement actions regarding misappropriation or misuse of investor assets,[18] the Commission revisited and amended its custody rule in 2009 ("2009 custody rule").[19] The 2009 custody rule was meant to "put [investors'] minds at ease" as stated by SEC Chair Mary Shapiro after several high profile fraud cases, including the Madoff case, "caused investors to question whether their assets are safe when they entrust them to an investment adviser."[20] The final rule was adopted a mere seven months after being initially proposed; this was evidence not only of the worrisome loopholes in the custody rule still ripe for exploitation but also of intense concern about the crisis of confidence among investors placing their money in the hands of registered investment advisers.

The 2009 custody rule addressed many of the loopholes exploited by the Madoff Ponzi scheme, and it enhanced protections surrounding client funds and securities held by registered investment advisers and qualified custodians. Specifically, the 2009 custody rule required

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[17] *Id*.

[18] *See* Custody of Funds or Securities of Clients by Investment Advisers, 74 Fed. Reg. 25,354, 25,355 n.11 (May 27, 2009) ("*See, e.g., SEC v. Donald Anthony Walker Young, et al.*, Litigation Release No. 21006 (Apr. 20, 2009) (complaint alleges registered investment adviser and its principal misappropriated in excess of $23 million, provided false account statements to investors in limited partnership, and provided false custodial statements to limited partnership's introducing broker); *SEC v. Isaac I. Ovid, et al.*, Litigation Release No. 20998 (Apr. 14, 2009) (complaint alleges that defendants, including registered investment adviser and manager of purported hedge funds, misappropriated in excess of $12 million); *SEC v. The Nutmeg Group, LLC, et al.*, Litigation Release No. 20972 (Mar. 25, 2009) (complaint alleges that registered investment adviser misappropriated in excess of $4 million of client assets, failed to maintain client assets with a qualified custodian, and failed to obtain a surprise examination); *SEC v. WG Trading Investors, L.P., et al.*, Litigation Release No. 20912 (Feb. 25, 2009) (complaint alleges that registered broker-dealer and affiliated registered adviser orchestrated fraudulent investment scheme, including misappropriating as much as $554 million of the $667 million invested by clients and sending clients misleading account information); *SEC v. Stanford International Bank, et al.*, Litigation Release No. 20901 (Feb. 17, 2009) (complaint alleges that the affiliated bank, broker dealer, and advisers colluded with each other in carrying out an $8 billion fraud*); SEC v. Bernard L. Madoff, et al.*, Litigation Release No. 20889 (Feb. 9, 2009) (complaint alleges that Madoff and Bernard L. Madoff Investment Securities LLC (a registered investment adviser and registered broker-dealer) committed a $50 billion fraud"); *see also* Statement, SEC Chair Mary Shapiro (Dec. 16, 2009), https://www.sec.gov/news/speech/2009/spch121609mls-custody.htm.

[19] Custody of Funds or Securities of Clients by Investment Advisers, 74 Fed. Reg. 25,354 (May 27, 2009).

[20] Statement, SEC Chair Mary Shapiro (Dec. 16, 2009), https://www.sec.gov/news/speech/2009/spch121609mls-custody.htm.I.

registered investment advisers to undergo an annual surprise examination by an independent public accountant to verify client funds and securities. It also required custodians to transmit account statements directly to advisory clients, and it required non-independent custodians to obtain a report on the internal controls of custodian services from an independent public accountant registered with the PCAOB. Taken together, these amendments were a direct response to the gaps in the regulation of custody of client assets that Bernie Madoff exploited.

Since the 2009 custody rule has been adopted, the markets have continued to evolve and to change dramatically in some respects, largely due to technology. The digitization of securities and other assets has altered the nature of the adviser-client relationship and the methods used to custody assets. Cryptocurrency assets in particular, regardless of whether they meet the traditional definition of a security or commodity, have emerged as speculative investments that investors have eagerly sought to purchase and sell. While they may present unique challenges for qualified custodians and registered investment advisers with respect to custody, an adviser's fiduciary relationship with their client requires that those assets be safeguarded no less carefully than any other fund, security, or asset.

OVERVIEW OF THE PROPOSAL

The Proposal would amend and redesignate Commission rule 206(4)-2 (the custody rule) under the Investment Advisers Act of 1940 as new rule 223-1 (the safeguarding rule) and make a number of important enhancements to ensure the protection of client assets managed by registered investment advisers.

Scope of Assets

In line with the additional authority granted to the Commission by Congress in section 411 of the Dodd-Frank Act, the Proposal expands the scope of assets subject to the current custody rule beyond "client funds or securities" to include any client "assets." This expanded definition would apply the new safeguarding rule not only to client funds and securities, but also to a broad range of other assets or "positions" a registered investment adviser may custody for their clients, including derivatives, physical investments, and cryptocurrencies, to name a few.

Definition of "Custody"

The Proposal maintains the current custody rule's definition of "custody" to apply when an adviser "holds, directly or indirectly, client assets, or has any authority to obtain possession of them." However, the Proposal clarifies that the safeguarding rule would be triggered when a registered investment adviser has discretionary trading authority over an investor's assets. Specifically, the amended custody definition would include any arrangement under which the registered investment adviser is authorized or permitted to withdraw or transfer ownership of investor assets.

Qualified Custodians

The Proposal strengthens the current requirement that registered investment advisers custody client assets with "qualified custodians." The Proposal would continue to allow banks or savings associations, registered broker-dealers, registered futures commission merchants, and certain foreign financial institutions to serve as qualified custodians. However, the Proposal would require qualified custodians to have "possession or control" of client assets, as opposed to the current requirements that they simply "maintain" client assets. Additionally, the Proposal would impose new conditions on banks and savings associations seeking to serve as "qualified custodians" by requiring them to segregate client assets to protect such assets from creditors of the bank or savings association in the event of a failure or insolvency. The Proposal also imposes several new conditions on foreign financial institutions that wish to serve as "qualified custodians."

The Proposal would also require registered investment advisers to enter into written agreements with qualified custodians to ensure adequate protection of advisory client assets. These written agreements would require the adviser to obtain reasonable assurances from a qualified custodian related to standard of care, indemnification, limitation of liability for sub-custodial services, segregation of assets, and attachment of liens on client assets. In addition, the qualified custodian would be required to provide: the client and the adviser with account statements (quarterly); the adviser an internal control report from an independent public accountant (annually); and records related to the client's assets to the Commission or independent accountant upon request.

Segregation of Client Assets

The Proposal would require registered investment advisers to segregate client assets from the adviser's assets in instances where the adviser has custody of such assets. Specifically, client assets in the adviser's custody would be required to (1) be titled or registered in the client's name or held for the benefit of the client; (2) not be commingled with the adviser's assets; and (3) not be subject to any right, charge, security interest, lien, or claim in favor of the adviser or its creditors (except to the extent agreed to or authorized in writing by the client).

Exception for Privately Offered Securities

The Proposal expands the custody rule's existing exception from the requirement to maintain certain privately offered securities with a qualified custodian by also exempting certain physical assets. However, the exception for both privately offered securities and physical assets would be limited and only available if the adviser reasonably determined custody could not be maintained by a qualified custodian. In addition, the adviser would have to take reasonable steps to prevent loss or theft; submit to independent public accountant audits; notify its independent public accountant of purchases, sales, or transfers of the asset; and allow surprise examinations or annual audits of the assets.

Amendments to the Surprise Examination Requirement

The Proposal would amend the current surprise examination requirement by requiring a written agreement between the adviser and an independent public accountant, which the adviser reasonably believes will be performed and which complies with Commission filing and notification requirements. The Proposal also amends the notice requirement by requiring any finding of a material discrepancy by an independent public accountant to be sent to the Commission's Division of Examinations.

Books and Records and Form ADV

Registered investment advisers would be subject to relevant recordkeeping requirements and supplemental questions on Form ADV, as specified in the Proposal.

COMMENTS

I. EXPANDING THE SCOPE OF ASSETS SUBJECT TO THE SAFEGUARDING RULE IS CONSISTENT WITH THE NEED TO MODERNIZE CUSTODIAL PRACTICES, AND IT ALIGNS WITH CONGRESSIONAL INTENT.

One of the central reforms in the Proposal is expanding the types of assets subject to the custody requirements. This is certainly consistent with the need to modernize custodial practices to keep pace with changes in the financial markets. It also aligns with the intent of Congress, which fortified investment adviser custodial requirements in the Dodd-Frank Act. And it will undoubtedly serve the ultimate regulatory goal, which is "to safeguard client funds and securities from the financial reverses, including insolvency, of an investment adviser and to prevent client assets from being lost, misused, stolen, or misappropriated."[21]

The custody rule has been updated several times within the past two decades to better reflect modern custodial practices. For example, when the original rule was adopted in 1962, advisers with custody of client funds and securities were required to segregate funds in a separate bank account and segregate securities in a reasonably safe place.[22] These requirements reflected custodial practices at a time when owning securities meant owning physical stock certificates. When the Commission decided to revisit the rule in 2003, the Commission modernized the requirements of the custody rule to mandate the custody of *securities* with qualified custodians, in addition to client funds, which were already required to be kept with a custodian.[23] This was necessary and appropriate in the eyes of the Commission due to concerns "that some advisers were still keeping certificates in office files or safety deposit boxes, which put those securities at risk."[24] At a time of increasing digitization of the markets and the rise of electronic trading of securities,

21 Release at 14,673.
22 Release at 14,673.
23 Release at 14,673.
24 Release at 14,673.

especially relative to 1962 when the custody rule was originally adopted, an update to the rule was necessary and appropriate.

When the Commission updated the custody rule again in 2009, they did so to close loopholes in the custody rules and to bolster public confidence in the investor advisory business. These loopholes, as mentioned above, were exploited by fraudsters like Bernie Madoff to misappropriate client funds and securities, inflicting tens of billions of dollars in investor losses. The 2009 amendments improved the custody rule by extending it to advisers accessing funds or securities through related persons, expanding the requirements for surprise annual examinations, and requiring advisers to obtain independent public accountant reports of its internal controls if the adviser or related person served as the qualified custodian.[25] Again, the Commission modernized the custody rule to close loopholes that had evolved in modern custodial practices to better ensure investors' funds and securities were not misappropriated by their investment advisers.

The Proposal would, once again and consistent with the Commission's practice of updating rules as necessary, modernize the custody rule to better reflect modern custodial practices, including by expanding the scope of assets beyond just funds or securities. Specifically, the Proposal would expand the scope of assets subject to the custody requirement to include all assets that advisers custody for their clients, regardless of whether or not they are funds or securities. This expansion was explicitly granted by Congress in the Dodd-Frank Act, in Section 411. As the Commission seeks to modernize its custody rule to better align with modern custodial practices, it is necessary and appropriate for the Commission to include this expansion in the scope of assets subject to the custody requirements, especially in response to the alarmingly reckless custodial practices developing in the cryptocurrency industry—as discussed below.

II. THE RECENT CRYPTOCURRENCY CARNAGE AND INVESTOR LOSSES IN RELATED BANKRUPTCIES PROVE THE NEED FOR STRONGER CUSTODY REQUIREMENTS.

Despite the clear application of the 2009 custody rule to most cryptocurrencies, investors in cryptocurrency securities have collectively lost billions of dollars to misappropriation, theft, and bankruptcies. The short history of cryptocurrencies is marked by extremely volatile markets; brazenly fraudulent schemes, hacks, and scams; and innumerable failures and bankruptcies leading to billions of dollars of investor losses. In many ways, the same financial schemes and frauds observed throughout history have been revived and repackaged as "innovation" in the form of cryptocurrency investment opportunities. This trend confirms the vital need to update and expand the custody rule to ensure that registered investment advisers are adequately safeguarding their client's cryptocurrency securities and cryptocurrency assets.

The most significant aspect of the cryptocurrency market is the prevalence of fraud and manipulation. In a 2021 white paper, Deloitte estimated that up to 90% of the trading volume in

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[25] Release at 14,674.

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cryptocurrencies could be subject to manipulation.[26] The schemes used to manipulate the cryptocurrency markets run the gamut, from pump-and-dump schemes, spoofing, and layering to wash sales. Fraud and outright theft are also prevalent in the cryptocurrency markets, with Chairman Gary Gensler of the Securities and Exchange Commission referring to them as the "Wild West."[27] Reports of cryptocurrencies being used in fraudulent transactions abound, with the Federal Trade Commission reporting that cryptocurrencies were by far the most frequently used means of investment-related fraud and theft online, making up the majority of all online investment-related fraud.[28] In 2021 alone, cryptocurrency frauds and scams resulted in $14 billion in losses.[29]

The most egregious fraud to date in the cryptocurrency industry was that perpetrated by FTX, culminating in the arrest of its founder Sam Bankman-Fried in December of 2022. According to the SEC's complaint, from at least May 2019 to November 2022, Bankman-Fried misappropriated and commingled billions of dollars of investor funds from his unregulated cryptocurrency exchange with his affiliated hedge fund, Alameda Research LLC, funds which he proceeded to squander, give away, or lose.[30] After declaring bankruptcy, FTX's new CEO, John Ray, testified before Congress that "never in my career have I seen such an utter failure of corporate controls at every level of an organization, from the lack of financial statements to a complete failure of any internal controls or governance whatsoever."[31] He cited the commingling of assets, lack of documentation of investments made with FTX funds and assets, lack of storage of private keys, and absence of audited financial statements as just some of the complete failures that enabled such a fraud to occur and to go undetected for a prolonged period. As the SEC and Congress responded to Bernie Madoff's Ponzi scheme by tightening custody rules for investment advisers, the Commission should also respond to the cryptocurrency meltdown by modernizing its custody rule to ensure that registered investment advisers are safeguarding their client's cryptocurrency securities and assets.

Chairman Gensler has correctly explained on several occasions that most cryptocurrencies almost certainly fall under the definition of a security.[32] Likewise, Chairman Gensler has noted

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[26] Deloitte, Market Manipulation in Digital Assets 2 (Mar. 10, 2021), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/gx-design-market-manipulation-in-digital-assets-whitepaper-v2-1.pdf.

[27] Gary Gensler, Chairman, SEC, Remarks Before the Aspen Security Forum (Aug. 3, 2021).

[28] Emma Fletcher, Reports show scammers cashing in on crypto craze, FEDERAL TRADE COMMISSION (June 3, 2022), https://www.ftc.gov/news-events/data-visualizations/data-spotlight/2022/06/reports-show-scammers-cashing-crypto-craze.

[29] *Id.*

[30] Securities and Exchange Commission v. Samuel Bankman-Fried, No. 1:22-cv-10501 (S.D.N.Y. 2022).

[31] *Investigating the Collapse of FTX, Part I: Hearing Before the H. Comm. on Fin. Serv.*, 117th Cong. (2022) (statement of John J. Ray III, CEO, FTX Group).

[32] Gary Gensler, Chairman, SEC, Remarks Before the Aspen Security Forum (Aug. 3, 2021) ("many of these tokens are offered and sold as securities…these products are subject to the securities laws and must work within our securities regime"); Gary Gensler, Chairman, SEC, Interview with

recently that the five largest platforms that facilitate the purchase and sale of those securities make up 99 percent of all such trading and likely facilitate the trading of more than 100 digital asset tokens.[33] These platforms that facilitate hundreds of billions of dollars in securities trading, largely to retail investors, are already subject to the 2009 custody rule.[34] Fortunately, for purposes of the Proposal's new safeguarding rule, the question of whether or not a given cryptocurrency token is a security is not at issue. By expanding the scope of assets subject to the safeguarding rule, as this Proposal does, a determination of whether or not an asset is a security is irrelevant. All assets, including all cryptocurrency assets, would fall under the safeguarding rule as they should.

The Proposal cannot, of course, address all of the many serious risks that the cryptocurrency markets pose to investors, including fraud, manipulation, and volatility. It can, however, address major sources of risk that go hand in hand with the crypto markets, including misappropriation, insolvency, and theft. For these reasons, and to strengthen custody requirements for the benefit of all other investment adviser clients, the Commission should move expeditiously to finalize the Proposal.

III. THE ECONOMIC ANALYSIS AMPLY SATISFIES THE COMMISSION'S LEGAL OBLIGATION TO ASSESS THE IMPACT OF THE PROPOSAL.

Industry opponents of SEC rules frequently claim that they fail a cost-benefit test, and specifically that they will prove too costly. The Proposal, once finalized, may well be subject to these attacks. As a general matter, however, these arguments are unfounded, both legally and factually. They distort the Commission's legal obligation to conduct economic analysis; they exaggerate the alleged costs and burdens of compliance with the new rules; and they downplay if not ignore the enormous benefits that the rules will confer, both individually and as part of a collection of rules that will work together to achieve market reforms. But this strategy should not sway the Commission or persuade it to dilute any reforms it deems necessary and appropriate to protect investors and the integrity of the markets. Throughout the rulemaking process, the Commission must be guided above all by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry. Certainly, as to this Proposal, the Commission has fulfilled its limited obligation to evaluate the impact of the reforms on efficiency, competition, and capital formation.

CNBC (Jan. 10, 2022) ("…if they call themselves a token, they are still probably, possibly a security"); Gary Gensler, Chairman, SEC, Prepared Remarks of Gary Gensler on Crypto Markets, Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022) ("The [BlockFi] settlement made clear that crypto markets must comply with time-tested securities laws").

33 Gary Gensler, Chairman, SEC, Prepared Remarks of Gary Gensler on Crypto Markets, Penn Law Capital Markets Association Annual Conference (Apr. 4, 2022).

34 Release at 14,676.

As we have explained,[35] under the securities laws, the Commission has no statutory duty to conduct a cost-benefit analysis. In reality, its far more limited obligation is simply to consider, "***in addition to the protection of investors***, whether the action will promote efficiency, competition, and capital formation."[36] The Supreme Court has long recognized that statutorily mandated ***considerations*** "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[37]

Nevertheless, the SEC also voluntarily undertakes its customary assessment of the potential costs and benefits of its rule proposals. Often, it confronts and identifies insurmountable challenges involved in cost-benefit analysis, explaining that many of the benefits and costs are "difficult to quantify" and observing that the data needed to quantify these economic effects "are not currently available and the Commission does not have information or data that would allow such quantification."[38] The Commission's evaluation of costs and benefits therefore understandably and inevitably turns largely to a qualitative discussion of the economic effects of a proposal.[39] All of that should come as no surprise. The Commission's rules are designed primarily to protect investors and maintain the integrity of the markets, while at the same time taking into account efficiency, competition, and capital formation. But it is difficult to even attempt placing precise dollar amounts on such benefits. How do you quantify the monetary, let alone non-monetary, benefits to investors of preventing fraud, embezzlement, or loss of funds due to insolvency? Or the larger yet more amorphous benefits of instilling investor confidence in their investment advisers or in the capital markets generally?

These are appropriate observations about the inevitable difficulties surrounding attempts at quantitative cost-benefit analysis; they are not failings of the Commission that suggest any legal infirmities in the proposals. As the D.C. Circuit has explained, in *Nat'l Ass'n of Mfrs. v. SEC*,[40] "An agency is not required to measure the immeasurable, and need not conduct a rigorous, quantitative economic analysis unless the statute explicitly directs it to do so"—a burden that Congress never saw fit to impose on the Commission.

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[35] For example, in 2012, we issued a report examining and exposing the largely successful attempt to foist more stringent cost-benefit analysis requirements upon the SEC, even though the securities laws include no such mandate. *See, e.g.,* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (July 30, 2012), https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf. In addition, we have updated the report; BETTER MARKETS, THE ONGOING USE AND ABUSE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION (Mar. 23, 2023), https://bettermarkets.org/wp-content/uploads/2023/03/BetterMarkets_Report_Cost_Benefit_Analysis_03-2023.pdf. We incorporate those two reports by reference as if fully set forth herein.

[36] *See* 15 U.S.C. § 77b(b) (emphasis added); 78 U.S.C. § 78c(f); 15 U.S.C. § 80a-2(c); 15 U.S.C. § 80b-2(c).

[37] *Sec'y of Agric. v. Cent. Roig Ref. Co.,* 338 U.S. 604, 611 (1950).

[38] *See, e.g.,* Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices (File No. S7-17-22, RIN 3235-AM96), 87 Fed. Reg. 36,654; 36,698 (June 17, 2022).

[39] *Id.* at 36,698.

[40] 748 F. 3d 359 (D.C. Cir. 2014).

Indeed, Better Markets has consistently argued that quantitative cost-benefit analysis is, for a host of reasons, a poor methodology for evaluating financial regulation: It is unreliable, speculative, and biased in favor of industry's relentless concerns with minimizing compliance costs while maximizing profits. Moreover, it consumes far more in agency resources than it is worth and ultimately sets the stage for a court challenge instigated by the disgruntled members of industry.[41]

The rationale for Congress's decision to impose only a flexible obligation to consider three discrete economic factors is clear: requiring the Commission to conduct a resource-intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives. The industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") does not change the securities laws, the reasoned basis for those laws, or the underlying policies. The Commission was established for the purpose of implementing the securities laws, and its primary duty is to achieve the legislative objectives of those laws: protecting investors and the public interest.[42]

The Proposal makes clear that in this rulemaking, the Commission has done all that is required in terms of economic analysis. In a section spanning nearly 30 pages in the Federal Register, the Commission has evaluated, to the extent it can, the costs and benefits associated with the Proposal.[43] That discussion illustrates a core point about cost-benefit analysis in the realm of financial regulation: quantification is immensely difficult. Here, the Commission has been able to estimate some dollar amounts or hours of work required in the projected compliance effort, yet it was forced to offer a predominantly qualitative assessment of the very significant benefits that will accrue from the Proposal once finalized.[44]

However, as explained above, that is no basis on which to attack the rule; rather, it simply confirms the daunting and ultimately pointless task that many, in the industry and unfortunately in the courts, expect agencies to undertake as they seek to promulgate rules in the public interest. Above all, the Commission must be sure to properly account for the considerable public benefits

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41 BETTER MARKETS, THE ONGOING USE AND ABUSE OF COST-BENEFIT ANALYSIS IN FINANCIAL REGULATION (Mar. 23, 2023), https://bettermarkets.org/wp-content/uploads/2023/03/BetterMarkets_Report_Cost_Benefit_Analysis_03-2023.pdf; BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (July 30, 2012), https://bettermarkets.com/sites/default/files/Setting%20The%20Record%20Straight.pdf.

42 The SEC should routinely make clear that while it is considering the costs and benefits as part of the rulemaking process, it is not doing so pursuant to its interpretation of any statutory requirements. Otherwise, the rule may be struck down for failure to "properly" conduct a quantitative cost-benefit analysis, although none is explicitly required by statute. *See, e.g., Am. Equity Inv. Life Ins. Co.*, 613 F.3d 166, 177 (D.C. Cir. 2010).

43 *See* Release at 14,733-761.

44 *See* Release at 14,741-756.

that come with strengthening the requirements surrounding the safe custody of client assets by registered investment advisers and bolstering public confidence in our capital markets.[45] Finally, with respect to the one genuine legal obligation to evaluate the impact of the Proposal on efficiency, competition, and capital formation, the Commission has certainly done its job.[46]

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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45 *Cf.* BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING 66-69 (2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf (explaining the huge costs of the 2008 financial crisis and highlighting the need for a holistic approach to the benefits of regulation).

46 *See* Release at 14,756-57.