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United States Senate

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BANKING, HOUSING, AND URBAN AFFAIRS

COMMERCE, SCIENCE, AND TRANSPORTATION

ENVIRONMENT AND PUBLIC WORKS

May 8, 2023

Ms. Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

(submitted electronically)

Re: Proposed Rule on Safeguarding Advisory Client Assets (File No. S7-04-23)

Dear Ms. Countryman,

Thank you for the opportunity to comment on the proposed rule published by the Securities and Exchange Commission (SEC) relating to safeguarding advisory client assets.[1]

Interest of the Senators

As a United States Senator and member of the Senate Banking Committee, I have a unique interest in the crucial issues addressed by this proposed rulemaking. Safeguarding advisory client assets is an issue that impacts the securities, commodities and banking industries, and one that has unique implications for both federal and state regulators under our system of dual banking.

My home state of Wyoming also has a distinct interest in the sweeping changes proposed by this rule, as my state is amongst the jurisdictions of choice for investment advisers, trust companies and custodial services in the financial services industry. Wyoming has a strong regulatory framework for the safeguarding of client assets, including strong capital requirements for custodians, legal certainty relating to the treatment of assets, a robust examination framework and best practices for cybersecurity.[2]

The Positive Impacts of the Proposed Rule

After a multi-year process, the SEC is to be commended for publishing the Proposed Rule to modernize the regulation and supervision of custody for investment advisers. I recently called for the SEC to complete this process as part of the *Lummis-Gillibrand Responsible Financial Innovation Act* in 2022.[3]

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[1] Sec. and Exch. Comm'n, Safeguarding Advisory Client Assets, 88 Fed. Reg. 14672 (Mar. 9, 2023), *available at* https://www.federalregister.gov/documents/2023/03/09/2023-03681/safeguarding-advisory-client-assets (hereinafter Proposed Rule).

[2] *See, e.g.,* Wyo. Div. Banking, *Special Purpose Depository Institution Custody and Fiduciary Examination Manual*, January 2021, https://drive.google.com/file/d/14dA8hrR59aGsKZYxAolWQ7dVr32cr_Vw/view (last visited Apr. 28, 2023) and Wyo. Div. Banking, *No-Action Letter on Custody of Digital Assets and Qualified Custodian Status*, Oct. 23, 2020, https://drive.google.com/file/d/1eXDrTinDW5PmPHvDvGe-TJQSElMO5tnT/view (last visited Apr. 28, 2023).

[3] S. 4356, § 304, 117th Cong., 2d Sess.

Since the Custody Rule[4] was first adopted in 1962,[5] and last revised in 2009,[6] custodial practices have changed dramatically, and custodians have faced new opportunities and risks through technological innovations such as digital assets and distributed ledger technology. The importance of robust custodial practices has also been exemplified during this time through scandals, including those perpetrated by Bernie Madoff, MF Global and FTX.com.

I am pleased that the SEC is seeking to extend the remit of custodial standards to additional classes of assets not currently contemplated by the Custody Rule, specifically extending protections to "funds, securities, or other positions held in a client's account."[7] This will provide important protections for customers as our financial markets continue to undergo the transformation we are witnessing today. I similarly agree that including the authority of an adviser to dispose of custodial assets on a discretionary basis on behalf of a client should be within the remit of custodial services.[8] Discretionary authority naturally places customer funds, securities and other positions within the professional judgment of the adviser, and therefore places them at risk of loss.

Additionally, the Proposed Rule posits a number of valuable reforms to client agreements. It is common sense that advisers should be required to provide records relating to client assets under custody to the SEC or the adviser's independent public accountant upon request.[9] Investment advisers should also be required to clearly specify the level of discretion they maintain with respect to a client custodial account as part of a written agreement.[10] These valuable enhancements provide transparency and certainty to advisory clients in a manner that is long overdue.

<u>Areas Where Further Work Is Needed</u>

Digital asset markets are a growing sector of the financial services industry, and desperately in need of robust regulation, like the *Lummis-Gillibrand Responsible Financial Innovation Act.*

The Proposed Rule specifies that "[a] qualified custodian must maintain possession or control of your [the advisors'] client's assets pursuant to a written agreement between you [the adviser] and the qualified custodian…"[11] "Possession or control" is defined as:

> [H]olding assets such that the qualified custodian is required to participate in any change in beneficial ownership of those assets, the qualified custodian's participation would effectuate the transaction involved in the change in beneficial ownership, and the qualified custodian's involvement is a condition precedent to the change in beneficial ownership.

Safe custody of digital assets is especially important because of the bearer nature of most digital assets, which makes robust safeguarding practices around private key material essential.

Understanding that the concept of "possession or control" is essential to the new Proposed Rule, I encourage the SEC staff to provide further detail in commentary to the Proposed Rule or in supplementary staff guidance relating to how satisfactory possession or control may be achieved with respect to a digital asset. For example, the Wyoming Digital Asset Custody and Fiduciary Manual states the following:

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[4] 17 C.F.R. 275.206(4)-2.

[5] *See* Sec. and Exch. Comm'n, Custody or Possession of Funds or Securities of Clients, 44 Fed. Reg. 2149 (Feb. 27, 1962)

[6] *See* Sec. and Exch. Comm'n, Custody of Funds or Securities of Clients by Investment Advisers, 75 Fed. Reg. 1455 (Dec. 30, 2009).

[7] Proposed Rule, at 14677.

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.* at 14780.

...[e]xclusive control or possession, as applicable, [is] based on a holistic analysis of the following factors on a facts-and-circumstances basis:

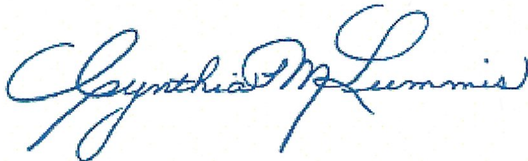
> (1) The SPDI possesses sufficient private key material to effect an on-ledger transaction without approval or coordination from another key holder.
> (2) Whether the SPDI creates new private keys for assets under custody, or merely provides safekeeping services for customer-generated private keys.
> (3) Whether the SPDI uses code-reviewed software, including smart contracts, to generate private keys without bank employee access, if new keys are created under (2) above.
> (4) Whether interacting with or moving private keys to hot wallets is similarly restricted to code-reviewed software without bank employee access, including smart contracts.
> (5) Whether SPDI employees have access to clear-text private keys at any stage of the custody process.
> (6) Whether the SPDI has policies and procedures in place governing private key generation designed to prevent SPDI employee access and which appropriately addresses the role of: (a) private key software-related development by bank employees; and (b) information technology staff access in the case of operational failures or errors.
> (7) Whether new private keys are created at the time a digital asset is returned to the customer and the method in which the asset is returned, or whether the bank returns the private key used by the SPDI.[12]

While it is important that the Proposed Rule remain principles-based, the safety of customer digital assets today could be greatly enhanced if the SEC were to provide further guidance on how possession or control may be achieved.

The concept of "possession or control" interacts heavily with the "satisfactory control location" requirement contained in the Customer Protection Rule.[13] Ideally, the standards for possession or control under both the new Proposed Rule and the Customer Protection Rule should be identical. In the past, staff have indicated that "exclusive control" was the requisite standard under the Customer Protection Rule, which implies that processes and procedures were required to be in place such that only the custodian had the unilateral ability to dispose of an asset. The proposed definition of "possession or control" specified above implies that exclusivity is no longer a material factor in determining possession or control.

It would be valuable for the Proposed Rule to provide further commentary on how the Proposed Rule and the Customer Protection Rule interact, and whether exclusivity remains a material factor under these rules.

Sincerely,



Cynthia M. Lummis
United States Senator

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[12] Wyo. Div. Banking, *Special Purpose Depository Institution Custody and Fiduciary Examination Manual*, January 2021, at 330, available at https://drive.google.com/file/d/14dA8hrR59aGsKZYxAolWQ7dVr32cr_Vw/view (last visited Apr. 28, 2023).
[13] 17 C.F.R. 240.15c3-3.