PATRICK McHENRY, NC
CHAIRMAN

MAXINE WATERS, CA
RANKING MEMBER

United States House of Representatives
One Hundred Eighteenth Congress
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

May 10, 2023

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

Re: Release No. IA-62240; File No. S7-04-23

Dear Ms. Countryman,

We write to express our strong concerns with the Securities and Exchange Commission (SEC)'s proposed rule, "Safeguarding Advisory Client Assets" (Proposed Rule).[1] The rule deviates significantly from traditional custody practices and would dramatically increase the cost of offering custodial services. Additionally, the SEC is using its authority to regulate registered investment advisors (RIAs) as a backdoor to regulate entities outside of its jurisdiction. Even more concerning is the Proposed Rule's lack of a comprehensive economic analysis. The SEC's explanation that it "is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs"[2] is unacceptable and indicates a reckless approach to rulemaking. We urge the SEC to withdraw the Proposed Rule and reconsider its approach to regulating entities outside of its jurisdiction.

SEC Authority

Like many of the agency's other rulemakings, the Proposed Rule far exceeds the SEC's statutory mandate. The Dodd-Frank Act expanded the SEC's authority to require RIAs to safeguard client assets.[3] However, this expansion was only intended to apply to assets within the SEC's jurisdiction. The Proposed Rule, in contrast, extends to all assets, including art, cash, commodities, and nontraditional assets. By disregarding jurisdictional lines, the SEC is attempting to establish standards in areas that it has no authority to regulate. Finally, the Proposed Rule impedes the jurisdiction of other regulators by imposing custody rules on entities that already have their custody practices regulated by another regulator.

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[1] SEC, Release No. IA-6240, *Safeguarding Advisory Client Assets* (Feb. 15, 2023), https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.
[2] *Id.* at 242.
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, Sec. 411.

Reshaping Traditional Custody

The Proposed Rule would fundamentally reshape traditional custody practices for market participants, even though the SEC acknowledges that custodians have a long history of "innovating and modernizing their practices" and "developing different procedures for safeguarding a variety of assets."[4] For example, the Proposed Rule would lower the negligence standard required for indemnification from gross negligence to simple negligence. This is a significant departure from traditional custody practice and would impose significant new costs on qualified custodians. The rule would also require a qualified custodian to have "insurance arrangements in place" to "adequately protect the client" in the event of custodial negligence.[5] As negligence could be extended to cover the loss of a client's assets outside of the qualified custodian's control, this insurance would be exorbitantly expensive and difficult to find.

The manner in which each of these requirements would be implemented – by requiring RIAs to enter into a written agreement with qualified custodians – is a substantial departure from industry practice. Renegotiating existing custodial contracts and agreements to accommodate the new requirements would be incredibly costly. Moreover, providing custodial services is already expensive, and many qualified custodians offer this service with very narrow profit margins. As a result, the proposed new requirements would substantially increase the cost of serving as a qualified custodian and potentially make the practice of providing custodial services for RIAs untenable. This, in turn, will reduce the number of eligible qualified custodians and diminish much-needed competition in our markets.

Additionally, the asset neutral approach threatens to undermine banks' most basic function, holding cash. This rule would require qualified custodians to hold cash in segregated accounts, like securities, rather than a general deposit account. Furthermore, equating cash to securities would be extremely harmful, reducing banks' access to liquidity and their ability to offer certain necessary services to their clients. This impact would further limit their ability to offer custody services at scale.

Impact on Digital Assets

The Proposed Rule would have an outsized impact on digital asset market participants, as entrepreneurs and companies within the ecosystem already struggle to find banks willing to custody their assets. Recent joint statements from the federal banking regulators have discouraged federally chartered banks from holding digital assets or even holding the deposits of digital asset firms.[6] As a result, many digital asset companies have opted to custody their assets with state-chartered banks and trusts. Thus, the question in the proposal regarding whether qualified custodians should be limited to federally chartered entities is highly concerning,

[4] *Supra* note 1 at 79.
[5] *Id.* at 86.
[6] *See* OCC, FDIC, and the Federal Reserve, *Joint Statement on Crypto-Asset Risks to Banking Organizations* (Jan. 3, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf; OCC, FDIC, and the Federal Reserve, *Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities* (Feb. 23, 2023), https://www.fdic.gov/news/financial-institution-letters/2023/fil23008a.pdf.

especially as it applies to digital assets.[7] More broadly, restricting state-chartered banks and trusts from acting as qualified custodians would only serve to further entrench incumbents and prevent necessary competition in our banking sector.

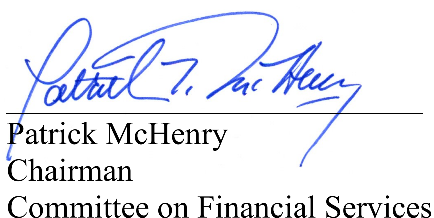
The SEC also fails to consider how the Proposed Rule would interact with Staff Accounting Bulletin (SAB) 121.[8] Under the combined rules, banks that serve as qualified custodians would not only have to fully indemnify digital assets from loss, but they would also have to hold the digital assets on their balance sheets and capitalize against them. This is not only overly onerous but extremely costly, potentially preventing larger, established qualified custodians in the form of public company banks from providing custody services to digital assets.

Therefore, the Proposed Rule not only prevents smaller, new entrants from engaging in digital asset custody, but also prices out many large institutions from offering the service at scale. The extreme disincentives that this rule creates for firms serving as qualified custodians for an RIA could lead clients to hold assets outside of the regulatory framework and with fewer consumer protections.

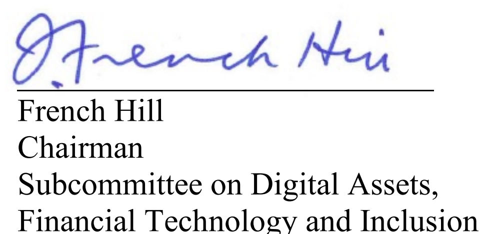
Conclusion

In conclusion, the Proposed Rule follows the SEC's pattern of promulgating rules that go beyond the SEC's authority and fail to provide a sufficient, statutorily-mandated economic analysis. Moreover, the Proposed Rule fails to consider the interconnectedness of the proposal with other SEC rulemaking, discouraging firms from serving as qualified custodians for RIAs and imposing major consequences for market participants. Additionally, the Proposed Rule would have particularly harmful impacts to the digital asset ecosystem. We urge the SEC to withdraw the Proposed Rule and remain committed to holding the SEC accountable for seeking to continue to expand its jurisdiction.

Sincerely,



Patrick McHenry
Chairman
Committee on Financial Services



French Hill
Chairman
Subcommittee on Digital Assets,
Financial Technology and Inclusion

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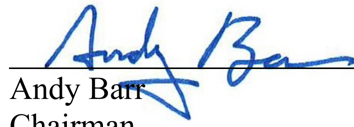
[7] *Supra* note 1 at 52 (posing the question, "should the rule permit only banks or savings associations that are subject to Federal regulation and supervision to act as qualified custodians?").
[8] SEC, Staff Accounting Bulletin No. 121 (Apr. 11, 2022), https://www.sec.gov/oca/staff-accounting-bulletin-121.

Ann Wagner
Chairman
Subcommittee on Capital Markets



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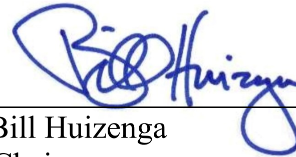

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